SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1918.

No. 914.

MARK EISNER, AS COLLECTOR OF UNITED STATES INTERNAL REVENUE FOR THE THIRD DISTRICT OF THE STATE OF NEW YORK, PLAINTIFF IN ERROR,

vs.

MYRTLE H. MACOMBER.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

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100060—19

1 UNITED STATES OF AMERICA, *ss:*

The President of the United States of America to the judges of the District Court of the United States for the Southern District of New York, greeting:

Because in the record and proceedings, as also in the rendition of the judgment of a plea which is in the district court before some of you, between Myrtle H. Macomber, as plaintiff, against Mark Eisner, as collector of United States internal revenue for the third district of the State of New York, a manifest error hath happened, to the great damage of Mark Eisner, defendant as aforesaid, we being willing that such error, if any hath been, should be duly corrected and full and speedy justice done to the parties aforesaid in this behalf, do command you, if judgment be therein given, that then under your seal, distinctly and openly, you send the record and proceedings aforesaid, with all things concerning the same, to the Supreme Court of the United States, in the city of Washington, District of Columbia, together with this writ, so that you have the same at the said place before the Supreme Court aforesaid on the 5th day of April, 1919, that the record and proceedings aforesaid being inspected, the said Supreme Court of the United States may cause further to be done therein to correct that error what of right and according to the law and custom of the United States ought to be done.

Witness the Honorable Edward D. White, Chief Justice of
2 the United States, this 7th day of March, in the year of our Lord one thousand nine hundred and nineteen and of the independence of the United States the one hundred and forty-third.

[SEAL.] ALEX. GILCHRIST, Jr.,
Clerk of the District Court of the United States of America for the Southern District of New York.

The foregoing writ is hereby allowed.

JNO. C. KNOX,
U. S. District Judge.

UNITED STATES OF AMERICA,
Southern District of New York, ss:

I, Alex. Gilchrist, jr., clerk of the District Court of the United States of America for the Southern District of New York, in the Second Circuit, by virtue of the foregoing writ of error, and in obedience thereto, do hereby certify that the following pages, numbered from four to twenty-four, inclusive, contain a true and complete transcript of the record and proceedings had in said court in the cause of Mark Eisner, as collector of United States internal revenue for the third district of the State of New York, plaintiff in error, against Myrtle H. Macomber, defendant in error, as the same remain of record and on file in said office.

In testimony whereof I have caused the seal of the said court to be hereunto affixed at the city of New York, in the Southern District of New York, in the Second Circuit, this twelfth day of March, in

the year of our Lord one thousand nine hundred and nineteen, and of the Independence of the United States the one hundred and forty-third.

[SEAL.] ALEX. GILCHRIST, Jr., *Clerk.*

3 L 19—19. Form No. 336. U. S. District Court, Southern District of New York. Myrtle H. Macomber, plaintiff, versus Mark Eisner, as collector of United States internal revenue for the third district of New York, defendant. *Writ of error.* Francis G. Caffey, United States attorney, attorney for defendant. Due service of a copy of the within is hereby admitted.

4 United States District Court for the Southern District of New York.

MYRTLE H. MACOMBER *against* MARK EISNER, COLLECTOR OF INTERNAL Revenue for the Third District of New York.	L 19–19.

To the above-named defendant:

You are hereby summoned to answer the complaint in this action, and to serve a copy of your answer on the plaintiff's attorney within twenty days after the service of this summons, exclusive of the day of service; and in case of your failure to appear or answer judgment will be taken against you by default for the relief demanded in the complaint.

Witness, the Hon. Learned Hand, judge of the District Court of the United States for the Southern District of New York, at the city of New York, this 30th day of July, in the year one thousand nine hundred and eighteen.

[SEAL.] ALEX. GILCHRIST, Jr., *Clerk.*

MURRAY, PRENTICE & HOWARD, *Plaintiff's Attorneys,*
Office and post-office address, 37 Wall St., Borough of Manhattan, New York City.

5 *Complaint.*

United States District Court, Southern District of New York.

MYRTLE H. MACOMBER, PLAINTIFF, *against* MARK EISNER, COLLECTOR OF UNITED States Internal Revenue for the Third District of the State of New York, defendant.	

The plaintiff for her complaint herein, by Murray, Prentice & Howland, her attorneys, alleges as follows:

1. That at all the times hereinafter mentioned the plaintiff was and now is a citizen of the State of New York and a resident of the third internal revenue district of the State of New York.

2. That at all the times hereinafter mentioned the defendant was and now is the collector of United States internal revenue for the third district of the State of New York.

3. That the Standard Oil Company of California is and was during the year 1916 a corporation organized and existing under and by virtue of the laws of the State of California. That on January 1st, 1916, said corporation had an authorized capital stock of one hundred million dollars ($100,000,000) divided into one million (1,000,000) shares of the nominal or par value of one hundred dollars ($100) each. That the authorized capital stock of said corporation then issued and outstanding was the sum of forty-nine million six hundred eighty-six thousand six hundred and fifty-six dollars ($49,686,656).

6 That on said date the said corporation had surplus and undivided profits which were invested in its plant, property, and business, and which were required for the purposes of the said corporation, amounting to the sum of forty-four million eight hundred and fifty-two thousand two hundred sixty-three and 2/100 dollars ($44,852,263.02). That of said surplus and undivided profits the sum of twenty million three hundred and fifty-three thousand sixty-eight and 34/100 dollars ($20,353,068.34) had been earned by said corporation prior to March 1st, 1913, and the balance of said surplus and undivided profits had been earned by said corporation subsequent to that date.

4. That at a meeting of the board of directors of said Standard Oil Company of California held on the 16th day of January, 1916, it was decided, for the purpose of readjusting the capitalization of said corporation, to issue additional shares of stock constituting an additional stock dividend of fifty per cent from the authorized capital stock of said company and to transfer from surplus account to capital stock account an amount equivalent to said stock dividend. That said board of directors duly adopted a resolution declaring said stock dividend, which said resolution was as follows:

"Whereas the issued capital stock of this corporation consists of 496,866–545614/983383 shares of a par value of one hundred dollars ($100) each; and

Whereas the unissued capital stock of this corporation consists of 503,133–437769/983383 shares; and

7 Whereas the net assets of this corporation exceed the par value of the issued capital stock by far more than twenty-five million dollars ($25,000,000), and the surplus of this corporation is greatly in excess of twenty-five million dollars ($25,000,000); and

Whereas said surplus has been derived from earnings of the corporation and profits of the business;

Now, therefore, be it

Resolved, That subject to the approval of the State authorities, a stock dividend of 248,133–272807/983383 shares of the capital stock of this corporation of the par value of one hundred dollars ($100) each be, and the same is, hereby declared payable on April 15, 1916, or as soon thereafter as delivery can be made, to the stockholders of this corporation of record on its books at close of business March 4, 1916, in the proportion of one-half of a share for each share of stock then so owned and held by each of said stockholders as shown by said books.

Resolved further, That the president and secretary of this corporation are hereby authorized and empowered to take whatever steps they may deem necessary to carry this resolution into effect and to notify the stockholders of the purport thereof."

8 5. That thereafter in accordance with said resolution the officers of the Standard Oil Company of California transferred from surplus account to capital-stock account, the sum of twenty-four million eight hundred forty-three thousand three hundred twenty-seven and 74/100 dollars ($24,843,327.74), being the equivalent of said stock dividend, and on the 15th day of April, 1916, issued to the stockholders of record of the said corporation on the 4th day of March, 1916, additional shares of stock in the proportion of one share of new stock for each two shares of old stock held by each stockholder on said date.

6. That on the 4th day of March, 1916, the plaintiff was the owner of two thousand two hundred (2,200) shares of stock of the Standard Oil Company of California, and on the 15th day of April, 1916, in accordance with the declaration of said corporation, the plaintiff received from the Standard Oil Company of California certificates representing additional shares of stock amounting to one thousand one hundred (1,100) shares.

7. That because of the issue of said additional shares constituting said stock dividend and of the increase in the number of parts in which the ownership of the assets of the corporation, as represented by its capital stock, was divided, the asset or book value of each share of stock, representing an equal aliquot part of the said total assets of said company, was proportionately decreased. That the number of shares of stock owned by each stockholder was increased by fifty per cent and at the same time the market value of each share was correspondingly decreased; that for the month prior to the declaration of said stock dividend and immedately thereafter sales of the stock of said corporation had been made in the open

9 market at a price of from three hundred sixty dollars ($360) to three hundred eighty-two dollars ($382) a share, and that during the period while the books were closed for said stock dividend and thereafter sales of stock were made in the open market at from two hundred thirty-four dollars ($234) to two hundred sixty-eight dollars ($268) per share. That the value of the capital stock owned

by each stockholder, including the plaintiff's shares, was substantially unchanged by reason of the declaration of said stock dividend and the issue of additional shares of stock.

8. That by resolution of the board of directors of the Standard Oil Company of California the amount charged from surplus account to the credit of the said capital account of the said corporation equivalent to the par value of said additional shares of stock constituting said stock dividend, being the sum of twenty-four million eight hundred forty-three thousand three hundred twenty-seven and 74/100 dollars ($24,843,327.74), was charged against surplus and undivided profits of said corporation earned prior to March 1st, 1913, in the sum of twenty million three hundred fifty-three thousand sixty-eight and 34/100 dollars ($20,353,068.34), and the balance of said sum, being the sum of four million four hundred ninety-thousand two hundred fifty-nine and 40/100 dollars ($4,490,259.40) was charged against the first surplus profits of the said corporation earned after March 1st, 1913. That 18.0743% of said first mentioned amount was charged against surplus and undivided profits earned since March 1st, 1913.

9. That in accordance with the provisions of the income tax law, being title 1 of an act of Congress in effect September 9, 1916, entitled "An act to increase the revenue, and for other purposes," the plaintiff in the year 1917 duly filed her return of income received during the year 1916. That in accordance with the regulations of the Treasury Department the plaintiff under protest included in her income tax return for the year 1916 the sum of nineteen thousand eight hundred seventy-seven dollars ($19,877), being the equivalent of 18.0743% of the par value of said additional shares of stock of the Standard Oil Company of California received by her and constituting said stock dividend, and that on the face of said return plaintiff stated that the same included 18.07% of said stock dividend of the Standard Oil Company of California declared and paid April 15, 1916, being the proportion of the par value of said shares constituting said stock dividend charged against earnings since March 1st, 1913. That at the time said return was filed, plaintiff accompanied the same with a protest in writing against the assessment of any tax on said additional shares of stock received by her constituting said stock dividend, or on any alleged equivalent thereof.

10. That thereafter the defendant, as collector of United States internal revenue for the third district of New York, claiming to act in pursuance of the provisions of title 1 of an act of Congress in effect September 9, 1916, entitled "An act to increase the revenue, and for other purposes," demanded of plaintiff the sum of eight thousand seven hundred twenty and 78/100 dollars ($8,720.78), which defendant claimed to be due and payable by her as an income tax for the year 1916. That included in the sum thus demanded as an income tax was the sum of one thousand three hundred and sixty-seven and

2/100ths dollars as an income tax imposed upon the amount of nineteen thousand eight hundred seventy-seven dollars ($19,877), being the equivalent of 18.0743% of the par value of the said one thousand one hundred (1,100) additional shares received by the plaintiff and constituting said stock dividend declared by the Stanard Oil
11 Company of California. That defendant threatened to enforce the payment of said tax, together with penalties and interest as provided in the act, by distraint and sale of property, and thereupon the plaintiff, solely to avoid the imposition of penalties and interest, and under compulsion, duress, and coercion, paid to the said defendant as such collector, on or about the 22nd day of May, 1917, the sum of eight thousand seven hundred twenty and 78/100 dollars ($8,720.78), of which the sum of one thousand three hundred sixty-seven and 2/100 dollars ($1,367.02) represented the tax imposed on the proportion of the par value of the additional shares constituting said stock dividend charged against earnings since March 1st, 1913, being 18.0743% thereof, but said payment was made under protest, and at the same time plaintiff protested in writing that no tax was due from her on said additional shares constituting said stock dividend and that the defendant was without authority to exact and collect the same, and that the plaintiff paid the same under duress and compulsion.

11. Thereafter the plaintiff duly took an appeal to the Commissioner of Internal Revenue and demanded repayment and refund of the said tax in accordance with the law and the regulations and rules of the Treasury Department. Said appeal was duly perfected and filed with the Commissioner of Internal Revenue on or about the 14th day of February, 1918, and that said appeal has been disallowed by said Commissioner of Internal Revenue.

12. That said additional shares constituting said stock dividend of the Standard Oil Company of California, as well in the proportion thereof charged against earnings and profits accrued since March 1st, 1913, as the proportion thereof charged against prior earnings and profits, did not constitute taxable income under the said act of Congress. That no tax was due or has become due thereon to the United States Government or to the defendant as col-
12 lector of United States internal revenue for the third district of New York, and the sum of one thousand three hundred sixty-seven and 2/100 dollars ($1,367.02), being the amount of tax paid thereon, was illegally and without warrant or authority at law demanded and collected by the defendant from the plaintiff.

13. That the act of Congress under which said sum of one thousand three hundred sixty-seven and 2/100 dollars ($1,367.02) was levied on said additional shares constituting said stock dividend as aforesaid, and its payment compelled, to wit, title 1 of an act of Congress in effect September 9, 1916, entitled "An act to increase the revenue, and for other purposes," is invalid and void, in so far as the same may be asserted to confer power to make such levy on said

additional shares constituting said stock dividend or to compel such payment, because in violation of the provisions of article 1, section 2, clause 3, of the Constitution of the United States, to the effect that "direct taxes shall be apportioned among the several States," and of the provisions of article 1, section 9, clause 4 thereof, to the effect that "no capitation or other direct tax shall be laid unless in proportion to the census or enumeration hereinbefore directed to be taken," and that said additional shares issued by the plaintiff as aforesaid, and constituting said stock dividend, did not in whole or in any part or proportion thereof constitute income and were not subject to taxation as income within the meaning of the provisions of the sixteenth amendment to the said Constitution, to the effect that "Congress shall have power to lay and collect taxes on incomes from whatever source derived without apportionment among the several States, and without regard to any census or enumeration"; and this plaintiff hereby draws in question the constitutionality of the said act of Congress and of all provisions thereof assumed or asserted to authorize the said levy and the enforcement thereof.

13 14. That no part of said sum of one thousand three hundred sixty-seven and 2/100 dollars ($1,367.02) has been repaid to the plaintiff, and the whole amount thereof with interest thereon from the 22nd day of May, 1917, remains due and owing from this defendant to the plaintiff.

15. That this is a suit of a civil nature at common law which arises under the Constitution and laws of the United States, and under the laws of the United States providing for internal revenue.

Wherefore, plaintiff demands judgment against the defendant for the sum of one thousand three hundred sixty-seven and 2/100 dollars ($1,367.02) with interest thereon from the 22nd day of May, 1917, together with the costs and disbursements of this action.

MURRAY, PRENTICE & HOWLAND,
Attorneys for Plaintiff, 37 Wall Street,
Manhattan, New York City.

STATE OF NEW YORK,
County of New York, ss:

Myrtle H. Macomber, being duly sworn, deposes and says that she is the plaintiff herein; that she has read the foregoing complaint and knows the contents thereof; and that the same is true of her own knowledge, except as to the matters therein stated to be alleged on information and belief, and that as to those matters she believes it to be true.

MYRTLE H. MACOMBER.

Sworn to before me this 15th day of June, 1918.

[SEAL.] ROBERT H. STRAHAN,
Notary Public #454, New York County.

(Endorsed:) U. S. District Court, S. D. of N. Y. Filed Aug. 3, 1918.

14 *Demurrer.*

United States District Court, Southern District of New York.

MYRTLE H. MACOMBER, PLAINTIFF,
against
MARK EISNER, COLLECTOR OF UNITED States internal revenue for the third district of the State of New York, defendant.

The defendant herein, by his attorney, Francis G. Caffey, United States attorney for the Southern District of New York, appearing herein, respectfully shows to this court and alleges:

The defendant demurs to the alleged cause of action set forth in the complaint upon the grounds:

1. That it appears upon the face thereof that the complaint does not state facts sufficient to constitute a cause of action.

Wherefore the defendant demands judgment that the complaint be dismissed together with the costs and disbursements of this action.

FRANCIS G. CAFFEY,
United States Attorney for the Southern District of New York, Attorney for the Defendant, Office and Post Office Address, Old Post Office Building, Borough of Manhattan, New York City.

15 Vincent H. Rothwell, assistant United States attorney, certifies that he has the within-entitled action in charge and that the above demurrer is not interposed for purpose of delay, and that he verily believes that the complaint is bad in law and that a determination of the question raised by the demurrer will terminate the litigation and so tend to expedite the disposition of the case.

VINCENT H. ROTHWELL,
Asst. U. S. Attorney.

(Endorsed:) U. S. District Court, S. D. of N. Y. Filed Oct. 11, 1918.

16 United States District Court, Southern District of New York.

MYRTLE H. MACOMBER,
vs.
MARK EISNER, COLLECTOR, ETC.

Memorandum.

Demurrer overruled on the authority of Towne *v.* Eisner, 245 U. S., 418; see also Peabody *v.* Eisner, 247 U. S., 347.

January 23, 1919.

JULIUS M. MAYER,
District Judge.

Filed Jan. 23, 1919.

17 *Order overruling demurrer with leave to answer.*

At a stated term of the United States District Court for the Southern District of New York, held in the United States Courthouse and Post Office Building, Borough of Manhattan, city of New York, on the 28th day of January, 1919.

Present: Honorable Julius M. Mayer, United States District Judge.

MYRTLE H. MACOMBER, PLAINTIFF,
against
MARK EISNER, AS COLLECTOR OF UNITED States internal revenue for the third district of the State of New York, defendant.

The issue of law raised by the demurrer of the defendant to the complaint of the plaintiff herein having duly come on to be heard by this court at a stated term thereof, and after hearing counsel for the defendant in support of said demurrer and counsel for the plaintiff in opposition thereto, and due deliberation having been had thereon, and the court having handed down its opinion overruling said demurrer,

Now, upon motion of Messrs. Murray, Prentice & Howland, attorneys for the plaintiff, it is

Ordered, that said demurrer be, and the same hereby is in all respects overruled, and it is further.

Ordered, that the defendant shall have twenty days from
18 the date of service of a copy of the order to serve and file the answer to the complainant herein.

JULIUS M. MAYER,
District Judge.

(Endorsed:) U. S. District Court, S. D. of N. Y. Filed Jan. 28, 1919.

19 *Order overruling demurrer.*

At a stated term of the United States District Court for the Southern District of New York, held in the United States Courthouse and Post Office Building, Borough of Manhattan, city of New York, on the 19th day of February, 1919.

Present: Honorable Julius M. Mayer, United States District Judge.

MYRTLE H. MACOMBER, PLAINTIFF,
against
MARK EISNER, AS COLLECTOR OF UNITED States internal revenue for the third district of the State of New York, defendant.

The issue of law raised by the demurrer of the defendant to the complaint of the plaintiff herein having duly come on to be heard by this court at a stated term thereof, and after hearing counsel for the

defendant in support of said demurrer and counsel for the plaintiff in opposition thereto, and due deliberation having been had thereon, and the court having handed down its opinion overruling said demurrer,

Now, upon motion of Messrs. Murray, Prentice & Howland, attorneys for the plaintiff, it is

Ordered, that said demurrer be, and the same hereby is in all respects overruled, and it further

20 Ordered, that the plaintiff have final judgment against the defendant on the merits for the relief demanded in the complaint herein, with costs to be taxed.

The court hereby certifies that there was probable cause for the acts of the defendant as collector of United States internal revenue for the third district of the State of New York.

JULIUS M. MAYER,
U. S. District Judge.

It is hereby stipulated by and between the attorneys for the respective parties herein that the shares of stock which were the subject of the stock dividend declared by the Standard Oil Company of California on January 16, 1916, as described in the complaint herein were assessed by the Commissioner of Internal Revenue at the par value thereof.

Dated New York, February 17, 1919.

MURRAY, PRENTICE & HOWLAND,
Attorneys for Plaintiff.
FRANCIS G. CAFFEY,
United States Attorney for Defendant.

(Endorsed:) U. S. District Court, S. D. of N. Y. Filed Feb. 19, 1919.

21 *Judgment.*

United States District Court, Southern District of New York.

MYRTLE H. MACOMBER, PLAINTIFF,
against
MARK EISNER, AS COLLECTOR OF UNITED States internal revenue for the third district of the State of New York, defendant.

The issues of law raised by the demurrer of the defendant to the complaint of the plaintiff herein having duly come on to be heard before the Honorable Julius M. Mayer, United States district judge, at a stated term of this court, and after hearing counsel for the defendant in support of said demurrer, and counsel for the plaintiff in opposition thereto, and due deliberation having been had thereon, and the court having handed down its opinion overruling said demurrer, and an order having been duly entered on the 19th day of February, 1919, overruling the said demurrer and ordering that the

plaintiff have final judgment against the defendant on the merits for the relief demanded in the complaint, and the court having certified that there was probable cause for the acts of the defendant as collector of internal revenue for the third district of New York, and the plaintiff's costs having been taxed in the sum of twenty-four & 22/100 dollars—

Now, on motion of Messrs. Murray, Prentice & Howland, attorneys for the plaintiff herein, it is hereby

Ordered and adjudged that the plaintiff, Myrtle H. Macomber, have final judgment against the defendant, Mark Eisner, as collector of United States internal revenue for the third district of the State of New York, for the sum of one thousand three hundred sixty-seven and 2/100 dollars ($1,367.02), with interest from the 22nd day of May, 1917, amounting to $143.53, together with the sum of twenty-four & 22/100 dollars costs as taxed, amounting in all to $1,534 77/100, and that execution issue therefor.

Judgment signed this 26th day of February, 1919.

ALEX. GILCHRIST, Jr.,
Clerk.

(Endorsed:) U. S. District Court, S. D. of N. Y. Filed Feb. 26, 1919, 11 a. m.

Assignment of errors.

United States District Court, Southern District of New York.

MYRTLE H. MACOMBER, PLAINTIFF, *against* MARK EISNER, AS COLLECTOR OF UNITED States internal revenue for the third district of the State of New York, defendant.	L 19–19.

Now comes Mark Eisner, as collector of United States internal revenue for the third district of the State of New York, the defendant herein, and assigns error in the decision of the United States District Court for the Southern District of New York, as follows:

First. The said court erred in overruling the demurrer interposed by the defendant to the bill of complaint herein and directing that final judgment should be entered in favor of the plaintiff.

Second. The court erred in holding that Section I of the act of Congress approved September 8th, 1916, is unconstitutional and void in that said section imposes a tax upon stock dividends, which are not income but capital.

Third. The court erred in construing and applying the decision of Towne against Eisner, 245 U. S., 418, and in overruling the demurrer upon any existing decisions of the Supreme Court of the United States or of any other court.

Fourth. The court erred in holding that the bill of complaint herein states a cause of action.

Fifth. The court erred in ordering that final judgment be entered upon the demurrer even if the bill of complaint does state a cause of action.

Wherefore the defendant prays that for the errors aforesaid the judgment be reversed with costs and that final judgment be entered in favor of the defendant.

Dated, New York, March 6, 1919.

FRANCIS G. CAFFEY,
United States Attorney for the Southern District of New York, Attorney for the Defendant.

(Endorsed:) U. S. District Court, S. D. of N. Y. Filed Mar. 7, 1919.

25 *Citation on appeal.*

UNITED STATES OF AMERICA, *ss:*

To Myrtle H. Macomber, greeting:

You are hereby cited and admonished to be and appear before the Supreme Court of the United States, to be holden at the city of Washington, District of Columbia, within thirty days from the date hereof, pursuant to a writ of error filed in the clerk's office of the District Court of the United States for the Southern District of New York, wherein Mark Eisner, as collector of United States internal revenue for the third district of the State of New York, is plaintiff in error, and you are defendant in error, to show cause, if any there be, why the judgment in said writ of error mentioned should not be corrected and speedy justice should not be done in that behalf.

Given under my hand at the borough of Manhattan, in the city of New York, in the district and circuit above named, this 7th day of March, in the year of our Lord one thousand nine hundred and nineteen, and of the independence of the United States the one hundred and forty-third.

JNO. C. KNOX,
Judge of the District Court of the United States for the Southern District of New York, in the Second Circuit.

26 (Endorsed:) Supreme Court of the United States. L 19-19. Mark Eisner, as collector of United States internal revenue for the third district of the State of New York, plaintiff in error, vs. Myrtle H. Macomber, defendant in error. Citation. Due service of a copy of the within citation is hereby admitted this 8th day of March, 1919. Murray, Prentice & Howland, attorneys for defendant in error.

(Endorsement on cover:) File No. 27000. S. New York, D. C. U. S. Term No. 914. Mark Eisner, as collector of United States internal revenue for the third district of the State of New York, plaintiff in error, vs. Myrtle H. Macomber. Filed March 13th, 1919. File No. 27000.

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In the Supreme Court of the United States.

OCTOBER TERM, 1918.

MARK EISNER, COLLECTOR OF INTERNAL REVENUE, Plaintiff in Error,
v.
MYRTLE H. MACOMBER. } No. 914.

IN ERROR TO THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF FOR THE UNITED STATES.

STATEMENT OF THE CASE.

This case involves the constitutionality of that provision of the Income Tax Law of 1916 which taxes as income of the stockholder *stock dividends* declared by a corporation *out of earnings and profits accruing subsequent to March 1, 1913.*

The taxes, amounting to $1,376.02, were paid under protest and this suit was brought to recover them.

The District Court, regarding the case of *Towne* v. *Eisner*, 245 U. S. 418, as controlling, rendered judgment for the amount claimed.

STATUTE INVOLVED.

Like the Act of 1913 (38 Stat., c. 16, pp. 114, 167), the Act of 1916 (39 Stat., c. 463, pp. 756, 757) provided that, for purposes of certain taxes and subject to certain exemptions and deductions—

> the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: * * *.

Unlike the Act of 1913, the Act of 1916 contains the following proviso:

> *Provided*, That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, *out of its earnings or profits accrued since March first, nineteen hundred and thirteen*, and payable to its shareholders, whether *in cash or in stock of the corporation*, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value.

This proviso makes the two Acts different in two respects: (1) The earlier simply taxed "dividends"

without any effort to define them; the later defines them so as to expressly include stock as well as cash dividends. (2) The earlier taxed "dividends" without reference to when the gains and profits represented by them accrued to the corporation; the later confines taxable dividends to those declared out of earnings and profits accruing to the corporation subsequent to March 1, 1913.

THE FACTS.

The defendant in error was the owner of 2,200 shares of the stock of the Standard Oil Company of California. On January 1, 1916, that company had surplus and undivided profits which were invested in its plant and other property required for its business, and which amounted to some $44,000,000. Of this sum, $20,000,000 had been earned prior to March 1, 1913, and the remainder after that date. On January 16, 1916, the directors declared a 50 per cent stock dividend. Accordingly, there was transferred from surplus account to capital stock account all the surplus earned prior to March 1, 1913, and enough of that earned subsequent to that date to make the amount so transferred equal to the par value of the new shares to be issued. The result was that about 18 per cent of each share issued in payment of the stock dividend was paid for out of earnings of the corporation accruing subsequent to March 1, 1913. Defendant in error received 1,100 of these shares. The tax was assessed and collected, however, on only 18 per cent of their par value,

thus taxing them only to the extent that they represented earnings accruing to the corporation after March 1, 1913.

QUESTION INVOLVED.

Congress has, in unmistakable language, declared its purpose to tax as income dividends of the kind above described. The only question is whether the levying of such a tax is within the power of Congress.

ASSIGNMENTS OF ERROR.

The assignments of error, which are found at pp. 11–12 of the record, present simply the question whether earnings accruing to a corporation subsequent to March 1, 1913, when distributed by means of a stock dividend, become taxable income in the hands of the stockholders.

BRIEF.

I.

Income, in general, as used in both the Corporation Excise Tax Law of 1909 and the Income Tax Law of 1913 has been defined "as the gain derived from capital, from labor, or from both combined." *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415; *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 183, 185.

II.

Stockholders have such an interest in the earnings and profits of a corporation that the same are within the power of Congress to tax as income even before they are divided. *The Collector* v. *Hubbard*, 12 Wall.

1; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, 336; *Lynch* v. *Turrish*, 247 U. S. 221, 228; *Bailey* v. *Railroad Company*, 22 Wall. 604, 635, 636; *Lynch* v. *Hornby*, 247 U. S. 339, 343.

III.

Congress having the right to tax undivided profits, this right cannot be destroyed by the issuance of stock certificates to represent such undivided profits, and since the certificates of stock issued in this case represent earnings of the corporation accruing subsequent to March 1, 1913, they are clearly made taxable as income by the Act of 1916, 39 Stat., c. 463, p. 756. *Peabody* v. *Eisner*, 247 U. S. 347; *Bailey* v. *Railroad Co.*, 22 Wall. 604, 635; *Swan Brewery Co., Limited* v. *The King*, Law Reports, Appeal Cases, 1914, pp. 231, 234–236.

IV.

Towne v. *Eisner*, 245 U. S. 418, does not control this case.

(1) That case merely decides that the stock dividends then before the court, paid out of earnings accruing prior to March 1, 1913, were not income within the meaning of the Act of 1913. Nothing said in the opinion can be construed as challenging the power of Congress to tax, as the income of stockholders, the profits of a corporation even before they are divided, and much less to tax a certificate of stock issued to represent such profits.

(2) The most that can be said of the opinion is that it holds that the term "dividend" in its ordinary acceptation does not include stock dividends, and that since the Act of 1913 used the term "dividend" without qualification stock dividends were not taxable under it. *Gibbons* v. *Mahon*, 136 U. S. 549, 559, 560.

(3) The Act of 1916, however, expressly taxes stock dividends, and hence *Towne* v. *Eisner* is not controlling.

V.

The case of *Lynch* v. *Hornby*, 247 U. S. 339, holding that cash dividends are to be treated as income for the year in which received, whether paid out of earnings accruing before or after March 1, 1913, in view of the reasons stated for the holding, would not have been inconsistent with a holding that stock dividends were taxable when representing earnings accruing ~~before~~ after March 1, 1913, but not taxable when representing earnings accruing ~~after~~ before that date.

But whether such holdings would have been inconsistent or not, the holding in *Lynch* v. *Hornby* is not controlling in this case, since the Act of 1916 makes it plain that dividends, whether paid in cash or stock, are to be taxed only when they represent earnings accruing after March 1, 1913.

VI.

While *Gibbons* v. *Mahon*, *supra*, holds that as between a life tenant and a remainderman stock dividends are not income, that case arose in the District

of Columbia, involves no Federal question, and is not controlling in similar cases arising in the State courts. As a matter of fact, most of the State courts have adopted a different ruling and hold that stock dividends are income. In the Act of 1916, therefore, Congress was clearly within its power when it declared that by "dividends" it meant either cash or stock dividends in accordance with the meaning of the term as understood and construed by the courts of most of the States. *Pritchitt* v. *Nashville Trust Co.*, 96 Tenn. 472; *Thomas* v. *Gregg*, 78 Md. 545; *McLouth* v. *Hunt*, 154 N. Y. 179; *Will of Pabst*, 146 Wis. 330; *Lord* v. *Brooks*, 52 New Hamp. 72; *Hite* v. *Hite*, 93 Ky. 257; *Moss's Appeal*, 83 Pa. State, 264; *Paris* v. *Paris*, 10th Vesey, Jr., 184; *Tax Commissioner* v. *Putnam*, 227 Mass. 522; *Matter of Osborne*, 209 N. Y. 450; *Goodwin* v. *McGaughey*, 108 Minn. 248.

VII.

The stock certificates which the defendant in error received represented his share of earnings accruing after March 1, 1913, and under the express terms of the Act constitute a part of his income.

ARGUMENT.

Congress has clearly enacted that when, out of earnings accruing subsequent to March 1, 1913, a corporation declares a dividend payable in its own stock, the shares of stock so received by stockholders shall be deemed to be a part of their income

and taxed accordingly. The Standard Oil Company declared such a stock dividend and paid it by issuing shares of its stock. The defendant in error received 1,100 of these shares, and was required to pay an income tax on 18 per cent, or, in round numbers, 198 of them. Manifestly this tax was properly collected, unless stock dividends can not, under any circumstances, be regarded as income.

WHAT IS INCOME?

Under both the Corporation Excise Tax Law of 1909 and the Income Tax Law of 1913 this court has had occasion quite recently to say what constitutes income within the meaning of the tax laws. This is the definition adopted:

> Income may be defined as the gain derived from capital, from labor, or from both combined. (*Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415; *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 183, 185.)

This definition is extremely broad and would seem to include anything of value which represents a gain derived from capital, labor, or both.

STOCKHOLDERS HAVE SUCH AN INTEREST IN THE EARNINGS AND PROFITS OF A CORPORATION THAT THE SAME ARE WITHIN THE POWER OF CONGRESS TO TAX AS INCOME EVEN BEFORE THEY ARE DIVIDED.

It is true that the title to the money and other assets of a corporation is in the corporation and not in the stockholders. It is equally true that a stockholder has no right to receive any part of the profits of a corporation except such as the board of directors,

acting in good faith, see fit to distribute as dividends. But it is idle to say that a corporation can accumulate profits without adding to the wealth of the stockholder, or that the latter do not *gain* by this accumulation. And it is not now open to controversy that such *gains* are within the power of Congress to tax as the income of the stockholders, even though undivided and held by the corporation as surplus. Indeed, this has been expressly adjudged by this court and does not seem to have ever been the subject of doubt.

The Income Act of 1864 required that there should be included in the taxable income of individuals, among other things, their share of the gains and profits of corporations, *whether divided or otherwise.* This court, in *The Collector* v. *Hubbard,* 12 Wall. 1, held the Act valid and said (p. 17):

> Decided cases are referred to, in which it is held that a stockholder has no title for certain purposes to the earnings, net or otherwise, of a railroad prior to the dividend being declared, and it cannot be doubted that those decisions are correct as applied to the respective subject matters involved in the controversies. Grant all that, still it is true that the owner of a share of stock in a corporation holds the share with all its incidents, and that among those incidents is the right to receive all future dividends; that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a mem-

> ber of the corporation until a dividend is made. Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift, or devise. Undivided profits invested in real estate, machinery, or raw material for the purpose of being manufactured are investments in which the stockholders are interested, and when such profits are actually appropriated to the payment of the debts of the corporation they serve to increase the market value of the shares, whether held by the original subscribers or by assignees. But the decisive answer to the proposition is that Congress possesses the power to lay and collect taxes, duties, imposts, and excises, and it is as competent for Congress to tax annual gains and profits before they are divided among the holders of the stock as afterwards, and it is clear that Congress did direct that all such gains and profits, whether *divided or otherwise*, should be included in estimating the annual gains, profits, or income liable to taxation under the provisions of that act. Annual gains and profits, whether divided or not, are property, and, therefore, are taxable.

True, under the doctrine of the *Pollock* case, that tax would have been held invalid, not, however, because the views just quoted were unsound, but because the tax was a direct tax on property and not apportioned among the States. Since the Sixteenth Amendment has removed the obstacle to levying such a tax, the *Hubbard* case, unless it has been overruled, is and was, when the recent income

tax laws were passed, conclusive authority of the power of Congress to levy a tax on defendant in error's share in the profits earned by the Standard Oil Company, even if they had never been divided by a declaration of a dividend of any kind.

The *Hubbard* case has never been overruled, modified, or questioned, but has been repeatedly recognized by this court. It has been quite recently cited with apparent approval, or at least with acquiescence, in *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, holding that the act of 1913 did not treat as income of the stockholders undivided profits of a corporation except "in case the company is formed or fraudulently availed of for the purpose of preventing the imposition of such tax by permitting gains and profits to accumulate instead of being divided or distributed." No lack of power to tax such undivided profits, if Congress had seen fit to do so, was suggested. Indeed, the court apparently approved what was said in the *Hubbard* case, and was careful to distinguish that case from the one then being decided, saying:

> The act is quite different in this respect from the Income Tax Act of June 30, 1864, c. 173, 13 Stat. 223, 281, 282, under which this court held, in *Collector* v. *Hubbard*, 12 Wall. 1, 16, that an individual was taxable upon his proportion of the earnings of the corporation although not declared as dividends. That decision was based upon the very special language of a clause of sec. 117 of the act (13 Stat. 282) that "the gains and profits of all

> ing the latter, in ordinary circumstances, as a part of his income for the purposes of the surtax, and not regarding the former as taxable income unless fraudulently accumulated for the purpose of evading the tax.
>
> This treatment of undivided profits applies only to profits permitted to accumulate after the taking effect of the act, since only with respect to these is a fraudulent purpose of evading the tax predicable.

In other words, under the act of 1913 the court found that *ordinarily* undivided profits of the corporation were not taxable as income of the stockholders, not because they were not, equally with dividends, within the power of Congress to tax, but because Congress, in exercising its discretion, had refrained from exerting its power on them.

It is obvious from what has been said that this court has repeatedly sustained the power exercised in 1864 to tax undivided profits of a corporation as income of the stockholders; has, since the passage of the act of 1913, more than once cited as authority the holdings to this effect; and has, by implication, at least, assumed that when, in the act of 1913, Congress, though to a limited extent, exercised the same power its act was valid. It is therefore submitted that the question of the power of Congress to tax the earnings of the corporation represented by the shares of stock involved in this case, even if no dividend of any kind had ever been declared, is foreclosed.

CONGRESS HAVING THE RIGHT TO TAX UNDIVIDED PROFITS, THIS RIGHT COULD NOT BE DESTROYED BY THE ISSUANCE OF STOCK CERTIFICATES TO REPRESENT THESE UNDIVIDED PROFITS.

Since Congress had ample power to tax as income of a stockholder his share of the *undivided* profits of a corporation, it follows, as a matter of course, that anything issued by the corporation and delivered to the stockholder to represent these taxable undivided profits must itself be taxable. The point is that the undivided profits being taxable as income of the stockholders, if Congress sees fit to so tax them, can not be placed beyond the power of Congress merely by changing their form. If taxable when they are merely an incident to the original stock of the stockholder, it would be absurd to say that they are placed beyond the same taxing power by having their amount definitely fixed and by issuing a certificate of ownership. As long as they remain merely undivided profits, they are under the control of the board of directors. If the board of directors so wills, they may never be distributed to the stockholders in any form of dividend. What benefits the stockholder may receive from them, aside from the increased value which they give as stock, and what control he may have over them, are matters entirely subject to the will of the board of directors. If while his interest in them is in this uncertain state and subject to the will and discretion of others, they may, as we have seen, be treated as a part of his income, it is much clearer that they may be so treated when he holds, as representing them, a certificate of stock

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which prevents the board of directors from thereafter treating them as anything but capital, which has a market value, and which he is at liberty to dispose of and convert into cash.

It has been held, under the Act of 1913, that a dividend paid out of profits and earnings is taxable income of the stockholder, whether paid in cash or by the distribution in specie of property belonging to the corporation, including the stock of other companies. *Peabody* v. *Eisner*, 247 U. S. 347. The mere fact, therefore, that a dividend is paid in *corporate stock* does not prevent its being taxable income of the stockholder. The reason is that such stock has a value, and, whatever that value is, it has accrued to the stockholder as a result of his ownership of property. If the dividend is paid in the stock of the corporation declaring it, it still has the same value and still comes to the stockholder by virtue of his ownership of stock in the company. In both cases, as we have seen, it is merely the concrete evidence which determines the amount of the stockholder's *gain*. The mere declaration of a dividend, whether paid in cash or stock, does not make the stockholder any richer than he was the moment before the dividend was declared. The question is whether he is richer, to the extent of the amount he receives as a result of the dividend, than he was at the beginning of the taxable period.

To illustrate: If on March 1, 1913, one owned stock in a corporation of the par value of $1,000 and the

company had a surplus which made his stock worth $1,500, the latter amount represented his capital at the time the income-tax law became effective. If on March 1, 1914, it turned out that the company had made a profit of 10 per cent which it declared and paid in a cash dividend his capital would still be the same that it was the year before. If thereupon, and before any other earnings had accrued, the corporation had declared a 50 per cent stock dividend and issued to him stock to the amount of $500, this would not involve any gains on his part and his capital would still be the same. If, however, on March 1, 1913, the par value of his stock had been $1,000 and the company had no surplus, but it turned out that on March 1, 1914, the company had earned 50 per cent and declared a dividend of 50 per cent payable in stock, the earnings of the year would have thus been converted into capital of the corporation. But can it be doubted that the stockholder would have received gains on his investment to the extent of 50 per cent? Would the fact that these gains were invested in the stock of the company prevent Congress from treating them as income any more than if the company had first invested the profits in the stock of another company and then distributed the latter stock to its stockholders? Certainly the stockholder would at the end of the year be $500 richer than he was at the beginning of the year, and this increment would certainly have been derived from the possession of property in the shape of his original capital.

To illustrate again: The defendant in error received 198 shares of the stock of the Standard Oil Company as a dividend. They, of course, had a market value. It is even alleged in the bill that they could have been sold for more than two to one. They had come to him as his share of the earnings of the corporation. They were derived from his ownership of stock in that corporation. Suppose he had immediately sold them. Can it be doubted that every dollar realized would have been *income* received by him during that year? Certainly this would have been true if the dividend had been paid in the stock of another company and he had sold that. It would seem that there is no difference in principle between the two cases. In either event he has first received his gains in property and he has converted this property into cash.

Under former income-tax laws it has certainly never been doubted that a stock dividend is income of the stockholder. In the case of *Bailey* v. *Railroad Company*, 22 Wall. 604, a railroad company whose charter prohibited the declaring of more than 10% annually in dividends, and which had issued all the stock it was authorized to issue, had accumulated large profits which had been invested in the improvement of its railroad and facilities. It desired to distribute this surplus among its stockholders. It could not declare a stock dividend because its power to issue stock had been exhausted. It hit upon the expedient of issuing certificates which it called scrip dividends. This court examined these certificates,

and after setting out their provisions, showed that they possessed practically all the attributes of stock except that they carried no right to vote, and said that the fact that they did not confer the right to vote could not exempt them from liability under the Act, as dividends in stock did not entitle the holder to any additional vote. The whole argument was based on the idea that stock dividends would undoubtedly be taxable as income. Indeed, this was expressly stated as follows, at page 635:

> Stock dividends it is conceded are a proper object of taxation under the Internal Revenue Act, and if so, it is difficult to see why those certificates are not, as they differ from the former only in the fact that they do not confer the right to vote and that they may be cancelled by payment out of the future earnings of the company.

It must be remembered that it is not claimed that a stock dividend is always and necessarily income. The illustrations used above show that a stock dividend may be declared out of earnings and gains which had become the capital of both the corporation and the stockholder before the tax law became effective, and hence do not represent a gain accruing to the stockholder during the taxable period. The insistence simply is that such dividends are income whenever they, in fact, represent an actual gain to the stockholder during the taxable period. Since, as we have seen, a stock dividend, like any other property, may constitute a gain accru-

ing to the stockholder and thus be a part of his income, and since in this case the stock dividend in question is the concrete evidence of the gain accruing to the defendant in error after the 1st of March, 1913, it would seem that a contradiction in terms would be involved in saying that the value of these 198 shares of stock was not a part of his income.

Moreover, as has been repeatedly recognized by this court, these shares represent gains and profits of the corporation which Congress had the power to treat as a part of his income even if they had never been distributed by the declaration of any kind of a dividend.

The holding of this court above cited, to the effect that a stock dividend representing taxable gains and profits may be treated as income, is in accord with the view of the English courts. In *Swan Brewery Company, Limited*, v. *The King*, decided in 1914 and reported in Law Reports, Appeal Cases, 1914, at pages 231–236, the House of Lords, considering a stock dividend with regard to its liability for tax under the Dividend Duties Act of 1902 of Western Australia, said, pp. 234–236:

> The new shares were intended to be and were distributed among the shareholders; they were intended to be and doubtless are advantages to the allottees. The Supreme Court of Western Australia held that they were dividends within the meaning of the Act, and that duty was payable on their amount or value accordingly. What is there wrong in this?

The argument is that there has been no dividend and no distribution, because nothing has been divided and nothing changed. Where formerly there was one share, enhanced in value by its right to participate in the reserve fund, if the company, being solvent, should be wound up voluntarily, now there are two, possessed of the same right of participation, but for that very reason worth no more and no less together than the one share was worth before. Formerly the company had a certain amount of capital; now it has the same without diminution or increase either temporary or permanent. The change is but one of name. Formerly its funds were so much share capital and so much reserve, all invested in the business; now they are so much more share capital and so much less reserve, all invested in the business still, and still unchanged in total amount. The duty claimed is not, it is said, a duty on or in proportion to any advantage either to the company or the shareholder measured by the increased stability of the company's own position or the increased facility to the shareholder in marketing his shares; it is measured by and is levied upon the whole nominal value of the new shares allotted, which is not the same thing as the value of the advantage distributed. Is this argument sound?

Their Lordships agree with the Supreme Court of Western Australia in thinking that it is not. There can be no doubt that the new shares were distributed and were not the same things as the old ones. They certainly were supposed to be advantages to the members of

the company, none the less that the making of the issue was probably an advantage to the company also. In so flourishing a business doubtless they really were advantages. The new shares were credited as fully paid, and, what is more, they were fully paid, for after the allotment the company held £101,450 as capital produced by the issue of those shares and for that consideration, and no longer as an undivided part of its accumulated reserve fund. True, that in a sense it was all one transaction, but that is an ambiguous expression. In business, as in contemplation of law, there were two transactions, the creation and issue of new shares on the company's part, and on the allottees' part the satisfaction of the liability to pay for them by acquiescing in such a transfer from reserve to share capital as put an end to any participation in the sum of £101,450 in right of the old shares, and created instead a right of general participation in the company's profits and assets in right of the new shares, without any further liability to make a cash contribution in respect of them. In the words of Parker, *C. J.*, "Had the company distributed the £101,450 among the shareholders and had the shareholders repaid such sums to the company as the price of the 81,160 new shares, the duty on the £101,450 would clearly have been payable. Is not this virtually the effect of what was actually done? I think it is."

Their Lordships have therefore humbly advised His Majesty that the judgment of the Supreme Court of Western Australia was right, and that the appeal should be dismissed with costs.

In the present case if the corporation had paid this dividend in cash and the defendant in error had taken the cash received and purchased from the company 198 shares of its stock, no one would doubt for a moment that the cash received would have been taxable as a part of his income. What was actually done was that the company invested the money for him and delivered to him the shares of stock so purchased. Is there any conceivable difference in principle between the case supposed and that now under consideration?

It is respectfully submitted that the right of Congress to tax stock dividends as income is beyond doubt; that the Act of 1916 itself does this in express terms, so far as such dividends represent earnings accruing after March 1, 1913; that the defendant in error received his 198 shares of stock in payment of such a dividend; and that, upon well-established principles, he is liable for the tax collected.

TOWNE V. EISNER, 245 U. S. 418.

It will be insisted that the recent case of *Towne* v. *Eisner* conclusively determines that a stock dividend is not income. The contention is not sound. In the first place, as we have seen, in more than one case under consideration by the court at the same time that *Towne* v. *Eisner* was being considered, this court recognized the power of Congress to tax as income undivided profits and, consequently, stock dividends. Holdings to this effect were cited with apparent, if not express, approval. Cases so holding were cited

as authority. Certainly, no dissent from them and no purpose to overrule them was indicated. It can not be supposed, therefore, that the court entertained any idea that the decision or anything said in the opinion in *Towne* v. *Eisner* was in conflict with these cases.

In the next place, *Towne* v. *Eisner* involved only the right to tax under the Act of 1913 a stock dividend declared out of earnings which had accrued prior to March 1, 1913, and had therefore become capital as regards both the corporation and the stockholders before the tax Act became effective. The effect of the stock dividend, therefore, was merely to give to the stockholders certificates evidencing their ownership of profits which, so far as their liability for taxes were concerned, had, in fact, been capitalized on March 1, 1913. Since the Act of 1913 purported to tax only income accruing subsequent to that date, the language of Mr. Justice Holmes in summing up the case, "in short, the corporation is no poorer and the stockholder is no richer than they were before," was entirely logical and conclusive. It was only another way of saying that the new stock certificates merely evidenced the stockholder's title to what he owned when the Act became effective, and that hence they did not include any gain which had accrued subsequent to that date. If, however, the stock dividend in question had, as in this case, represented the stockholder's share of earnings accruing after March 1, 1913, the language quoted would have been inappro-

priate and, in fact, untrue. It would have been true, of course, that the stockholder was no richer the moment after than the moment before the declaration of the dividend, but this would have been beside the question. The real question would have been, was he richer to the extent of the value of the stock received, than he was on March 1, 1913. If so, he had derived from his ownership of stock in the corporation a gain or profit or income to that extent.

While the court did not find it necessary to go into any elaborate discussion of the facts, obviously Mr. Justice Holmes had in mind the fact that this dividend represented profits which, for the purposes of the income-tax law, had been capitalized on March 1, 1913, when he said, "we cannot doubt that the dividend was capital as well for the purposes of the Income Tax Law as for distribution between tenant for life and remainderman." This statement was immediately followed by a quotation from *Gibbons* v. *Mahon*, 136 U. S. 549, 559, 560, in which it was held that where under a will a person was entitled during his life to receive the dividends of stock, this meant cash dividends and stock dividends remained a part of the capital and belonged to the remainderman. As applied to the facts before this court, this holding was pertinent and controlling. The holding in *Gibbons* v. *Mahon* was based upon the view of the court that because the portion of the earnings of a corporation to be distributed among the stockholders was in the discretion of the board of direc-

tors, that board had the power, if it saw fit, to retain and use as capital so much of the earnings as it deemed expedient.

In other words, it was held that so long as the board of directors did not decide to distribute earnings in cash they must be considered to have determined to use and treat them as capital; and that the issuance of shares of stock to represent them was a final determination that, as between the corporation and the stockholders, they should permanently be regarded as capital. This could only mean that, the corporation having decided to appropriate earnings to capital, this decision was conclusive upon the stockholders, and that, as between them, such earnings could no longer be regarded as income. So the Act of 1913, for the purposes of taxation, capitalized the earnings which had been accumulated up to March 1, 1913. As, in the case of *Gibbons* v. *Mahon*, the certificates issued to represent earnings which the corporation itself had capitalized were held to be capital as between life tenant and remainderman, so in *Towne* v. *Eisner* shares of stock issued to represent earnings which, for the purposes of taxation, the law had capitalized on March 1, 1913, were held to be capital, since they did not include any element of gain to the stockholder which the Act of 1913 purported to tax. The element, therefore, which made the principle involved in *Gibbons* v. *Mahon* and that in *Towne* v. *Eisner* kindred was the fact that in neither case did the certificates represent anything which had not

already been established as capital. If, as in this case, it had appeared that the certificates in *Towne* v. *Eisner* represented earnings which the law purported to tax there would have been no similarity in principle between the two cases.

In the next place, unlike the Act of 1916, the Act of 1913 did not in express terms tax *stock dividends*. It merely taxed *dividends*. In the case of *Gibbons* v. *Mahon* it had been held that a provision in a will giving to a legatee the "dividends" of stock did not include in its terms stock dividends. That case did not hold, however, that a stock dividend may never or for any purpose be deemed income. It was merely held that "ordinarily a dividend declared in stock is to be deemed capital, and a dividend in money is to be deemed income, of each share." (p. 559.) The most that can be made of this is that it is a ruling to the effect that *ordinarily* the term "dividend," without qualification, means only a dividend paid in cash or its equivalent and not in stock of the company declaring it. Since the Act of 1913 used only the word "dividend," the court could very well feel bound by the ruling in *Gibbons* v. *Mahon*, to regard the language of the Act as excluding an intention to tax anything except a dividend as that word is *ordinarily* understood—that is, a dividend paid in cash or its equivalent, not including stock of the corporation declaring it. In this view, it is possible that under the Act of 1913 this court would have felt constrained to say that, for the want of the ex-

pression of a controlling purpose by Congress, the tax did not apply to a stock dividend regardless of when the earnings it represented had accrued. But what the court would have held under the Act of 1913 is not important in this case.

When the Act of 1916 was passed, although *Towne* v. *Eisner* had not been decided by this court, the question had been raised and was the subject of litigation. Congress, so far as the future was concerned, put an end to it by declaring in express terms that it meant in the Act of 1916 by the word "dividend," any distribution of earnings of the corporation accruing after March 1, 1913, whether paid to the stockholder in cash, property, or stock. This court may have intended to decide in *Towne* v. *Eisner* that no stock dividends were taxable under the Act of 1913, but certainly, in view of the authorities to which we have referred and which had the attention of the court while *Towne* v. *Eisner* was under consideration, it cannot be said to have decided, or intended to have decided, that Congress had no *power* to tax them as income. And Congress having now exercised that power, there is nothing in *Towne* v. *Eisner* which can control or affect this case.

It will be insisted that *Towne* v. *Eisner* turned rather upon the nature of stock dividends than upon the fact that the dividends there involved represented earnings accruing prior to March 1, 1913. In support of this contention it will be argued that in

no other way can that case be reconciled with *Lynch* v. *Hornby*, 247 U. S. 339, in which it was held that cash dividends paid after March 1, 1913, were to be treated as income for the year in which received regardless of whether the earnings being distributed accrued prior or subsequent to March 1, 1913. But *Lynch* v. *Hornby* was based upon the fact that Congress had chosen to tax a stockholder's interest in earnings and profits not as they accrued but when they ripened into dividends. Since dividends are the recognized means through which returns on investments in corporate capital are received, just as interest represents the return on money loaned, and rent the return for the use of land, the court was of opinion that Congress intended to tax such dividends whenever received regardless of when they were earned. This was in accord with the well-recognized character of corporate stocks and dividends.

As before mentioned, the stockholder is entitled to receive only such portion of the earnings as the board of directors see fit to distribute. In the ordinary course of business these are received periodically by the payment of dividends, and not infrequently are practically as fixed as to amount and date of payment as interest on loans. They are not necessarily paid out of the earnings of a particular year. Indeed, they may be paid for a year in which, instead of earning profits, the corporation has sustained a net loss. In such cases, if as a result of previous prosperous years, the corporation has ac-

cumulated a surplus it may, and often does, declare for the lean year a dividend not earned that year out of earnings of previous years. It may very well be said, then, that when Congress came to tax *dividends* as a source of income it was not necessary to inquire when the profits thus distributed were earned. It was manifestly upon this idea that the decision in *Lynch* v. *Hornby* was based, for, after holding that it was permissible to make the act retroactive to a date not prior to the adoption of the Sixteenth Amendment, the court said, pp. 343-344:

> And we deem it equally clear that Congress was at liberty under the Amendment to tax as income, without apportionment, everything that became income, in the ordinary sense of the word, after the adoption of the Amendment, including dividends received in the ordinary course by a stockholder from a corporation, even though they were extraordinary in amount and might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing. Dividends are the appropriate fruit of stock ownership, are commonly reckoned as income, and are expended as such by the stockholder without regard to whether they are declared from the most recent earnings, or from a surplus accumulated from the earnings of the past, or are based upon the increased value of the property of the corporation. The stockholder is, in the

> ordinary case, a different entity from the corporation, and Congress was at liberty to treat the dividends as coming to him *ab extra*, and as constituting a part of his income when they came to hand.

As we have seen, the utmost extent of meaning that can be attached to the opinion in *Towne* v. *Eisner* is that it construes the word "dividend" in the Act of 1913 to include only such dividends as have just been described. If the court, in fact, did intend to go this far, the result is that what was said in *Lynch* v. *Hornby* applies to the only kind of dividends mentioned in the Act, and that the effect of *Towne* v. *Eisner* is to hold that, since Congress had not exercised its undoubted power to tax a share of accumulated profits until distributed by means of such a dividend, stock dividends, which must represent either accumulated profits or capital, were not taxable under that Act. Assuming this to be true, the answer is that neither of these cases is controlling in the present case, which arises under the Act of 1916. Cash dividends representing earnings accruing prior to March 1, 1913, which were taxed in *Lynch* v. *Hornby*, could not be taxed under the Act of 1916, for the reason that that Act defines both cash and stock dividends as a distribution of earnings accruing after that date. Likewise, giving to *Towne* v. *Eisner* the full meaning claimed for it, and thus assuming that, if the dividends there considered had represented earnings accruing after March 1, 1913, they would nevertheless not have

been taxable, they would be under the Act of 1916, which, in express terms, puts stock dividends on the same basis with cash dividends.

Conceding, therefore, for the sake of the argument, that, under the Act of 1913, stock dividends were under no circumstances taxable, we have this situation: The stockholders in a corporation had such an interest in the gains and profits of the corporation that Congress had the power to treat each stockholder's share in these profits as they accrued as a part of his income. Congress had in previous Acts done this, and this court had held that its action was valid. But, when it came to pass the Act of 1913, in view of the obvious difficulties of fairly administering such a law without making it unduly burdensome upon and annoying to the taxpayer, Congress decided not to levy a tax upon them until they were divided and something definitely fixing the share of each stockholder delivered to him. It accordingly enacted that the tax should attach to these undivided profits only when they should be paid over to the stockholders in "dividends." Assuming all that is claimed for *Towne* v. *Eisner*, this meant cash dividends as distinguished from stock dividends, and a stock dividend would not be taxable. In that event, if the earnings had accrued subsequent to March 1, 1913, the shares of stock issued in payment of the stock dividend would merely represent undivided profits, which had not reached the point at which Congress had expressed an intention to tax them. They

would still, however, be undivided profits, and when these profits were realized by a sale of the shares of stock the proceeds, of course, would be taxable income.

But when Congress came to pass the Act of 1916, it evidently concluded that there was no reason for postponing the imposition of the tax beyond the time that the stockholder should receive his share of the profits in the shape of stock certificates, which had a market value and could readily be converted into cash. Instead, therefore, of saying that undivided profits should not be taxable until divided by means of a cash dividend, it enacted that the tax should be imposed whenever they were distributed, whether the dividend was paid in cash or stock. As we have seen, unless it can be said that although undivided profits may be taxed while merely an incident to ownership of the original shares, they can not be taxed when they have been converted into separate and distinct shares of stock, there can be no doubt Congress had the power to do what it did in the Act of 1916.

IT IS WITHIN THE PROVINCE OF CONGRESS TO DETERMINE WHAT ITEMS OF GAIN SHALL BE TREATED FOR THE PURPOSES OF TAXATION AS INCOME.

In levying an income tax, it is manifestly within the province of Congress to describe and define the items of gain which shall be taxed. It may be conceded that Congress can not arbitrarily call something which in no sense constitutes a gain "income"

and tax it as such. But in this case, as we have seen, it is impossible to say that subsequent to March 1, 1913, the defendant in error was not a gainer by the prosperous operations of the corporation in which he held stock. It is settled that these gains could have been taxed, although never divided or distributed. This being true, it can not be doubted that in fixing the time when the tax should be imposed it had as ample power to say that the tax should accrue when the profits should be turned over to the stockholder in the shape of additional shares of stock as to say that it should accrue when the stockholder received his share in cash. Congress used the word "dividend" as indicating when the tax should be imposed. At that time, it is probably safe to say that no court had ever expressly held that, for the purposes of an income tax, a dividend was any less income when paid in stock than when paid in cash. This court had held in *Gibbons* v. *Mahon* that, as between a life tenant and remainderman, a stock dividend was not income, and that, in the ordinary acceptation of the term, a dividend did not include one payable in the stock of the corporation. At the time that case was decided the authorities, even as to the rights of life tenant and remainderman, were by no means agreed. And at present, even in that class of cases, the courts of a great many of the States draw no distinction between cash and stock dividends. *Pritchitt* v. *Nashville Trust Co.*, 96 Tenn. 472, 489; *Thomas* v. *Gregg*, 78 Md. 545; *McLouth* v. *Hunt*, 154 N. Y. 179; *Will of Pabst*, 146 Wis. 330; *Lord* v. *Brooks*, 52 New Hamp. 72;

Hite v. *Hite*, 93 Ky. 257; *Moss's Appeal*, 83 Pa. State 264; *Matter of Osborne*, 209 N. Y. 450; *Goodwin* v. *McGaughey*, 108 Minn. 248. And in the English case of *Paris* v. *Paris*, 10th Vesey, Jr., 184, Lord Eldon said:

> As to the distinction between stock and money, that is too thin; and, if the law is, that, this extraordinary profit, if given in the shape of stock, shall be considered capital, it must be capital, if given as money.

In fact, in the *Will of Pabst*, 146 Wis. 330, it was said that the courts of nearly all the States now hold that there is no distinction, even in this regard, between the two kinds of dividends, the exceptions being limited, probably, to Rhode Island, Georgia, Massachusetts, Illinois, and Connecticut.

In *Gibbons* v. *Mahon, supra*, this court, when called on to decide whether a stock dividend, as between a life tenant and remainderman, was income or capital, found the authorities on that subject conflicting, and after full consideration adopted what has come to be known as the Massachusetts rule and held that *ordinarily* stock dividends are not to be treated as income. It has been seen that, even in this class of cases, that rule does not prevail in most of the States. In confirmation of the contention, moreover, that this rule does not go to the extent of holding that a stock dividend is *necessarily* capital, and therefore cannot, in the exercise of legislative power, be treated as income, it is interesting to know that this conten-

tion is in perfect accord with the decisions of the Massachusetts court. That court has quite recently had occasion to consider the power of the legislature to tax stock dividends as income, and, though still adhering to the rule that, as between life tenant and remainderman, such dividends are capital, has unequivocally held that the legislature, for the purposes of taxation, may treat and tax them as income. In the case of *Tax Commissioner* v. *Putnam*, 227 Mass. 522, it was said, at page 532:

> In the management of trusts as between a life tenant and remainderman rights to subscribe for stock, *Atkins* v. *Albree*, 12 Allen, 359, 361, *Davis* v. *Jackson*, 152 Mass. 58, 61, and stock dividends, *D'Ooge* v. *Leeds*, 176 Mass. 558, 560, *Rand* v. *Hubbell*, 115 Mass. 461, are regarded as capital and not as income in this Commonwealth. The rule of this Commonwealth, to the effect that as between life tenant and remainderman stock dividends are treated as capital and not as income, perhaps may have grown up in part at least by reason of its convenience and it appears to be widely adopted. *Gibbons* v. *Mahon*, 136 U. S. 549.
>
> But, however that may be, it is manifest that there is no inherent, necessary and immutable reason why stock dividends should always be treated as capital. This is apparent because in several jurisdictions they are treated either in whole or in part as income and not as capital.

The court then cited many of the cases which have been cited in this brief, and said:

> It seems impossible to say, when a kind of gain is in many States held even as between life tenant and remainderman to be income and not capital, that the word "income," used in an amendment to the Constitution adopted for the express purpose of enabling a tax to be levied broadly on all that rightly may be described as income, should be construed as excluding such gains simply because this court has held that it was not income in a single branch of law while numerous other courts have held the contrary even upon that point. However strong such an argument might be when urged as to the interpretation of a statute, it is not of prevailing force as to the broad considerations involved in the interpretation of an amendment to the Constitution adopted under the conditions preceding and attendant upon the ratification of the Forty-fourth Amendment. The rights to subscribe for stock, when sold and converted into cash, rightly may be treated as taxable as a gain on the sale of intangibles under section 5 (c) of the income-tax act. These rights commonly are represented by certificates and pass by indorsement. They are a species of intangible property. They are not regarded ordinarily as a profit from the prosecution of the business, but are an inherent and constituent part of the shares. *Atkins* v. *Albree*, 12 Allen 359, 361; *Hyde* v. *Holmes*, 198 Mass. 287, 293. Their sale resulted from an exercise of judgment to that effect on the part of the stockholder.

> They are indistinguishable in principle from a sale of the stock itself, and gains derived from sales of such rights fall within the same class of income.

And speaking directly of stock dividends, the court said, at page 535:

> But the words "distribution of capital" do not readily lend themselves to an issue of new stock, which in its last analysis represents surplus earnings of the corporation for the time being applied to increase of plant and which are intended to be continued to that use. In essence the thing which has been done is to distribute a symbol representing an accumulation of profits, which instead of being paid out in cash is invested in the business, thus augmenting its durable assets. In this aspect of the case the substance of the transaction is no different from what it would be if a cash dividend had been declared with the privilege of subscription to an equivalent amount of new shares. The stock dividend was declared strictly out of an accumulation of earnings applied to business uses and not out of increased market value of capital investment. See *Thayer* v. *Burr*, 201 N. Y. 155. That which the stockholder had before was a fractional interest in the property of the corporation. So far as concerned the accumulation of profits, there was a possibility that they might be paid out in whole or in part as a cash dividend by authority of the corporation. By the issue of the stock dividend that possibility is gone and the stockholder now has evidence of a permanent interest in

> the corporate enterprise of which he can not be deprived. It is a thing different in kind from the thing which the stockholder owned before. From the viewpoint of the stockholder, he has received in the form of dividend in stock a thing with which theretofore he could have no tangible dealings. The certificate for the new shares of stock representing the stock dividend may have a materially greater value than the less tactile right to a share in the accumulated profits which he had before. * * *
>
> The contention that stock dividends are not taxable as income, because in this Commonwealth they are treated as capital and not as income as between life tenant and remainderman, has been disposed of by what has been said already in discussing the second question here raised respecting the taxability as income of rights to subscribe for new shares of stock.
>
> The stock dividends, so far as regards the source from which they come to the stockholder and the impassive nature of his receipt of them, are derived from the same class of property from which are derived ordinary dividends and rightly may be classified with them under section 2 of the income-tax act. The two should be taxed, as they are in the statute, at the same rate.

It may be added that in this case, after placing stock dividends in the same class with cash dividends, the court upon the same reasoning, afterwards applied by this court in *Lynch* v. *Hornby*, held that both cash and stock dividends were taxable as income of the year in which received, regardless of whether the

earnings thus distributed had accrued to the corporation before or after the beginning of the taxable period

The case of *Gibbons* v. *Mahon* arose in the District of Columbia. It announces a rule of property involving no Federal question, and therefore is not controlling when similar questions come before the courts of the various States. The result is that in nearly all the States the term "dividend," even as used in the Act of 1913, would be understood and held to include both cash and stock dividends, while in cases arising in the District of Columbia and a few of the States the holding would be to the contrary. What Congress did in the Act of 1916 was not to call "income" something which had not theretofore been recognized as a gain, but merely, in view of the conflicting opinions of the courts as to what was meant by the word "dividend," to say what it intended by that word in the Act it was framing, namely, *any distribution of profits accruing after March 1, 1913, whether paid in stock or cash.* Surely, it cannot be said that in doing this Congress went beyond its power.

CONCLUSION.

It is respectfully submitted that the District Court was in error in supposing that this case was controlled by *Towne* v. *Eisner* and its judgment should be reversed.

Respectfully,

WILLIAM L. FRIERSON,
Assistant Attorney General.

APRIL, 1919.

FILED
MAR 15 1919
JAMES D. MAHER,
CLERK.

No. 914318

IN THE

Supreme Court of the United States,

OCTOBER TERM, A. D. 1918.

MARK EISNER, AS COLLECTOR, ETC.,
Plaintiff-in-Error,

against

MYRTLE H. MACOMBER,
Defendant-in-Error.

MOTION TO ADVANCE.

CHARLES E. HUGHES,
GEORGE WELWOOD MURRAY,
Counsel for Defendant-in-Error.

MURRAY, PRENTICE & HOWLAND,
Attorneys for Defendant-in-Error.

The Evening Post Job Printing Office, Inc., 156 Fulton St., N. Y.

IN THE

Supreme Court of the United States,

October Term, A. D. 1918.

No. .

MARK EISNER, AS COLLECTOR, ETC.,
PLAINTIFF-IN-ERROR,

AGAINST

MYRTLE H. MACOMBER,
DEFENDANT-IN-ERROR.

MOTION TO ADVANCE.

NOW COMES MYRTLE H. MACOMBER, THE DEFENDANT-IN-ERROR, AND MOVES THE COURT THAT THIS CAUSE BE ADVANCED ON THE DOCKET AND SET DOWN FOR HEARING UPON A DAY CERTAIN.

STATEMENT OF FACTS.

The writ of error in this case is brought to review the final judgment of the United States District Court for the Southern District of New York entered upon an order overruling the Collector's demurrer to the com-

plaint. The action was brought by a taxpayer to recover a tax assessed under the Income Tax Law of 1916 on the ground that it was illegally assessed. The plaintiff paid the tax under protest and took an appeal in due time to the Commissioner of Internal Revenue.

No technical question of practice is involved; the sole question is whether or not the tax was wrongfully assessed and collected.

The tax in question amounted to $1,367.02 and was paid as income tax for the year 1916. The plaintiff had received certain stock from the Standard Oil Company of California and the receipt of this stock was the sole basis for the tax. The question presented by the writ of error is whether that stock, which has been designated a "stock dividend", constituted taxable income.

Briefly the complaint alleges the following facts:

On January 1, 1916, the Standard Oil Company of California had outstanding capital stock in the amount of $49,686,656. and had accumulated a large surplus which was invested in its plant, property and business. In 1916 the Board of Directors of the corporation, for the purpose of readjusting the capitalization of the company, decided to issue additional shares of stock in the proportion of one-half of a share for each share of stock then owned by each stockholder, and in accordance with the resolution of the directors there was transferred from surplus account to capital stock account the sum of $24,843,327.74, being the equivalent

of the par value of said stock dividend. Of this sum $20,353,068.34 was charged against and represented surplus of the company earned prior to March 1, 1913, and $4,490,259.40 was charged against and represented surplus earned after March 1, 1913. The plaintiff held 2,200 shares of stock and received 1,100 shares of the new stock, which to the extent of 18.0743% represented earnings of the company since March 1, 1913. The remaining 81.9257% is not in question in this case. The defendant, acting under instructions from the Treasury Department, contended that all the new stock so received by the plaintiff constituted taxable income and levied a tax thereon on the theory that this stock was legally equivalent to a cash dividend at the rate of $100. a share.

By the receipt of this new stock the plaintiff's share or interest in the assets of the Standard Oil Company of California was not changed but the transaction merely increased the number of shares or parts into which her interest was divided; the market value of the plaintiff's total number of shares remained substantially the same and unaffected by the new issue of shares; before the surplus was capitalized the stock was selling at the price of from $360. to $382. per share, and after it was capitalized by this increase of fifty per cent in the number of outstanding shares the market price was from $234. to $268. a share.

The complaint alleges that the stock did not constitute taxable income under the Income Tax Law of September 9, 1916, and that no tax was due on it, and

that the Act of Congress under which said sum of $1,367.02 was levied on said additional shares, representative of the Company's earnings since March 1, 1913, and its payment compelled,—to wit: Title I of the Act of September 9, 1916,—is invalid and void in so far as the same may be asserted to confer power to make such levy on said additional shares constituting said stock dividend or to compel such payment because in violation of the provisions of Article I, Section 2, clause 3 of the Constitution of the United States and not within the terms of the Sixteenth Amendment.

The District Court expressly passed upon the constitutional question, following the decision of this Court in *Towne against Eisner, Collector*, 245 U. S. 418, and also referred to *Peabody against Eisner*, 247 U. S. 347.

The special and peculiar circumstances involved in the case and requiring a speedy hearing of the cause are as follows:

The Income Tax Law of 1916, Title I (39 Stat. 756, Chap. 463) provides:

> In Section 1 (*b*): "In addition to the income tax imposed by subdivision (*a*) of this Section (herein referred to as the Normal Tax) there shall be levied, assessed, collected and paid upon the total net income of every individual or in the case of a non-resident alien the total net income from all sources within the United States, an additional income tax * * *".

In Section 2 (*a*):

> "The net income of the taxable person shall include gains, profits and income derived from salaries, wages or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trades, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in any real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever; *Provided*, that the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association or insurance company out of its earnings or profits, accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value."

The Collector, plaintiff-in-error, acting under instructions of the Treasury Department, required the defendant-in-error to pay the tax of $1,367.02 above mentioned, being that proportion of her total tax upon the stock in question representative of the company's earnings since March 1, 1913, upon the theory and claim that the stock above referred to was income.

Numerous other citizens have been required by the public authorities to make similar payments. The authorities are now requiring payment of many others and still others are under the threat of imminent notice from the authorities requiring immediate payment. The sums directly involved amount to a considerable number of million dollars and the payments required, if not justified by law, form a considerable oppression of the citizens in question.

The questions involved and to be presented to the Court for its determination are these:

The construction of the Constitution and the constitutionality of the portions of the Income Tax of 1916 just above quoted. The case at bar concerns a direct tax which must be apportioned unless "stock dividends" are income under the Sixteenth Amendment of the Constitution.

It is the contention of the defendant-in-error that a "stock dividend" is not income under a proper construction of the Sixteeenth Amendment; that a stock dividend is not income to the stockholder receiving it but is a mere readjustment of the form of a capital obligation already owned (*Gibbons* v. *Mahon*, 136 U. S. 549); and that the case is controlled by the ruling of this Court in *Towne against Eisner*, 245 U. S. 418, and *Peabody against Eisner*, 247 U. S. 347.

These questions, directly affecting the administration of the revenue, are of grave importance and we

conceive it to be in the public interest that this case should be advanced.

CHARLES E. HUGHES,
GEORGE WELWOOD MURRAY,
Counsel for Defendant-in-Error.

MURRAY, PRENTICE & HOWLAND,
Attorneys for Defendant-in-Error.

The Plaintiff-in-Error consents that the above entitled cause be advanced upon the docket and set down for hearing by the Court. and joins in the request for advancement

Alex. C. King
Solicitor General.

No. [redacted]318

JUN 2 19[redacted]
JAMES D. MAHER,
CLERK.

IN THE

Supreme Court of the United States,

OCTOBER TERM, A. D. 1918.

MARK EISNER, AS COLLECTOR, ETC.,
Plaintiff-in-Error,

against

MYRTLE H. MACOMBER,
Defendant-in-Error.

MOTION TO ASSIGN FOR HEARING.

CHARLES E. HUGHES,
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Counsel for Defendant-in-Error.

MURRAY, PRENTICE & HOWLAND,
Attorneys for Defendant-in-Error.

The Evening Post Job Printing Office, Inc., 156 Fulton St., N. Y.

IN THE

Supreme Court of the United States,

October Term, A. D. 1918.

No. 914.

MARK EISNER, as Collector of Internal Revenue, Etc.,
Plaintiff-in-Error,

against

MYRTLE H. MACOMBER,
Defendant-in-Error.

MOTION TO ASSIGN FOR HEARING.

The Court having ordered this cause restored to the docket for reargument, now comes Myrtle H. Macomber, the defendant-in-error, and moves the Court that the cause be re-assigned for hearing upon the first Monday of October, 1919, or as soon thereafter as may suit the convenience of the Court.

Charles E. Hughes,
George Welwood Murray,
Counsel for Defendant-in-Error.

Murray, Prentice & Howland,
Attorneys for Defendant-in-Error.

The plaintiff-in-error consents that the above-entitled cause be re-assigned for hearing upon the first Monday of October, 1919, or as soon thereafter as may suit the convenience of the Court.

Solicitor General.

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In the Supreme Court of the United States.

OCTOBER TERM 1919.

MARK EISNER, COLLECTOR OF INTERNAL revenue, plaintiff in error,
v.
MYRTLE H. MACOMBER, DEFENDANT in error.
No. 318.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

SUPPLEMENTAL BRIEF FOR THE PLAINTIFF IN ERROR.

This case having been remanded to the docket for reargument, it may be helpful, in a supplemental brief, to restate as concisely as possible the contentions of the Government in view of what was said at the hearing and to reply specifically to some of the arguments advanced on behalf of the defendant in error.

THE CASE.

Briefly stated, the case is this:

During the year 1916, the defendant in error, being the owner of 2,200 shares of the stock of the Standard Oil Company of California, received, as a stock

dividend, 1,100 shares of the stock of that company, of which 198 and a fraction shares represented earnings which had accrued to the company subsequent to March 1, 1913. She was required to include the *par value* of these 198 shares in her taxable income for 1916, though the *market value* was much greater. Having paid the tax, she sued to recover it and has succeeded in the District Court.

STATUTE INVOLVED.

The case arises under the revenue act of 1916, 39 Stat. ch. 643, pp. 756, et seq.

Section 1 (a) imposes an income tax of 2 per cent, called the *normal tax*, on net incomes received in the preceding calendar year from all sources by *individuals*.

Section 10 imposes an annual tax of 2 per cent on net incomes received in the preceding calendar year from all sources by *corporations*.

Section 1 (b) imposes another annual tax, called the *additional tax*, on all net incomes of *individuals* in excess of $20,000. No tax corresponding to this is imposed on the income of *corporations*.

Section 2 (a) defines *net income* as including "gains, profits, and income *derived from* salaries, wages * * *, also from interest, rent, dividends" * * *, and defines dividends as—

> any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, *out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and* payable to its

> shareholders, *whether in cash or in stock of the corporation*, joint stock company, association, or insurance company, which stock dividend shall be comsidered income, to the amount of its cash value.

Section 5 (b) provides that income from *dividends upon the stock or from the net earnings* of corporations which are themselves taxable on their net incomes, shall be *excluded* from the taxable income of individuals for the purposes of the *normal tax*. And Section 1 (b) provides that such income shall be *included* for the purposes of the *additional tax*.

Section 3 provides that for the purpose of the *additional tax*, the taxable income of an individual shall include his share of the undivided profits of a corporation if they have been permitted to accumulate beyond the reasonable needs of the business for the purpose of evading the tax.

The pertinent features of the Act are:

1. Congress has assumed the power to tax corporate gains and profits as income of either the corpotion or the stockholders, but has been careful not to impose the same tax on the same gains as the income of both.

2. A tax of 2 per cent is laid alike upon the net incomes of individuals and of corporations. But there is excluded from the taxable income of individuals all amounts received from the net earnings of corporations whose income is subject to the tax. Congress thus elected to impose this particular tax on corporate gains as income of the *corporation* rather than of the stockholders.

3. In imposing the *additional tax*, the opposite course was pursued. It is not laid on the income of *corporations* at all, but only on the income of *individuals*. And there is an express provision that the income so taxed shall include income derived from the net earnings of corporations. Congress thus elected to impose this additional tax on corporate gains as income of the *stockholders* rather than of the *corporation*.

4. In both cases, the tax is imposed on the same corporate gains. The only difference is that, in one case, the corporation pays the tax before passing the gains to the stockholders for whose benefit they have been earned, while in the other the stockholder pays the tax after he has received his share of the gains.

5. Since the tax is imposed upon income derived from dividends on capital stock or from the net earnings of corporations, and since dividends themselves are derived from net earnings, the ultimate thing taxed is *income derived from the net earnings of corporations*.

6. Such income, when derived from earnings *accruing prior to March 1, 1913*, is not subject to either the normal or the additional tax.

7. When derived from earnings accruing *since March 1, 1913*, it is not subject to the *normal tax*.

8. When so derived, it is subject to the *additional tax* and is taxed *when received*.

9. Such income is deemed to be *received* during the calendar year in which it comes to the stockholder in the form of either a *stock* or a *cash* dividend,

or in which the corporation fraudulently permits its gains and profits to accumulate beyond the reasonable needs of the business.

QUESTION INVOLVED

The *purpose* of Congress to treat stock and cash dividends alike for purposes of the additional tax is plain beyond dispute. The sole question is whether it has the *power* to tax, as a stockholder's income, corporate gains and profits when they are received by him in the shape of additional stock issued as a stock dividend.

THE CONTENTIONS.

The defendant in error contends that the tax is levied *on stock dividends per se;* that such dividends are mere readjustments of the evidence of a person's ownership and give the stockholder nothing that was not already his; that he is no richer after than before the dividend and so receives no income; and that stock dividends, for these reasons, not being income, can not be made such by congressional enactment.

The Government contends that the tax is levied on *income derived from corporate earnings;* that such income may be taxed either as the earnings accrue to the corporation or when they are *received* by the stockholder; that the act taxes it when received, but defines the word "received" so as to include not only stock dividends but, in one contingency, accrued earnings, though undistributed; that stock issued as a stock dividend is one of the forms in which corporate gains

may be received, measures the extent to which such gains have made the stockholder richer, and is, in truth, the income which he has derived from capital invested in corporate stock.

The defendant in error seeks to make the test whether the mere declaration of a stock dividend makes the stockholder richer the moment after than he was the moment before.

The Government says the true test is whether his previous investment has made him richer to the extent of the profits distributed by means of a stock dividend.

ACT OF 1913 AS APPLICABLE TO CORPORATE EARNINGS.

After the adoption of the Sixteenth Amendment abolishing all distinctions between incomes as to the manner in which they were taxable, the work of Congress in formulating the policy of the Government with respect to income taxes began with the act of 1913 (38 Stat. ch. 16, pp. 114, 166). That act provided for a normal and also an additional tax to be imposed annually on net incomes of individuals "arising or accruing" from all sources during the preceding calendar year. For the purpose of the normal tax, net income was not to include "the amount received as dividends upon stock or from the net earnings of any corporation * * *" which is itself taxable upon its net income. But, for the purpose of the additional tax, there was to be included income from all sources, "corporate or otherwise."

The provisions for taxing income arising or accruing from corporate sources were, (1) to require a

stockholder to report, as a part of his income, all "dividends," and (2) to tax, as income of stockholders, profits permitted by a corporation to accumulate beyond the reasonable needs of the business. There was no effort to define dividends.

CHANGES MADE BY ACT OF 1916.

In framing the act of 1916, Congress must be assumed to have had in contemplation the act of 1913 and the controversies that had arisen under it. In so far as the two acts differ, it must be assumed that the purpose was to correct mistakes made through the use of language which was inapt to express what was really intended, or to make changes which experience had shown to be desirable. Important changes were made. The expression, "income accruing or arising" was discarded and the more definite expression, "income received" employed. But the most significant change was accomplished by adding a proviso to the effect that the term "dividends" shall be held to mean any distribution which a corporation makes or orders to be made—

> out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, . . .

It is thus made plain that whatever is received by way of a dividend of whatever kind, including stock dividends, is to be taxed, but only when the dividend is declared out of earnings accrued since March 1, 1913.

The net result is that the act by no means assumes the want of power to treat as stockholder's income corporate earnings either as they accrue to the corporation or when they are received by the stockholder. Nor has Congress refrained from exercising that power. On the contrary, the act is based on it. It is exercised by imposing the tax, according as circumstances seemed to require, on corporate earnings at every stage through which they ever pass from their accrual to their arrival in the pocket of a stockholder, as follows:

1. They are taxed while still undistributed and in the hands of the corporation if they have been permitted to accumulate beyond the needs of the business.

2. In the absence of such fraudulent accumulation, they are taxed only when they are distributed by means of either a cash or a stock dividend.

In either case, the tax is on the stockholder's share in corporate earnings. No purpose to entirely exempt such share is expressed or implied. It is exempt only so long as it remains a part of such undivided profits as are reasonably necessary to the business. The moment it assumes any one of the forms named—fraudulently accumulated profits, cash dividend, or stock dividend—it is to be taxed.

THE FACTS.

On March 1, 1913, the Standard Oil Company of California, had a paid up capital of $49,686,656.00, represented by 496,866 and a fraction shares, and

undivided profits of $20,353,068.34, making the actual value of each share of stock, in round numbers $141.00.

On January 1st, 1916, it had the same paid up capital, $20,353,068.34 of profits earned *before* March 1, 1913, and $24,499,194.68 earned after that date, and the value of each share of stock was approximately $190.00. It decided, in the language of the act of Congress, to *distribute* $24,843,327.74 of its accumulated earnings or, in the language of counsel for defendant in error, to *readjust* the evidence by which the stockholders held their interests in the corporate assets. Accordingly it declared a 50 per cent stock dividend and issued 248,433 and a fraction new shares of stock which it distributed among its stockholders.

To accomplish this, it capitalized all the profits which had been earned prior to March 1, 1913, and $4,490,259.40 which had been earned later, leaving $20,008,935.28 of the latter earnings undistributed. Since there were then outstanding 745,299 shares of stock, the value of each share was about $127.00. Approximately 18 per cent of the profits capitalized, distributed, or readjusted had thus accrued since March 1, 1913. The stockholders, as a whole, had their original 496,866 shares, 203,530 shares representing the earnings up to March 1, 1913, and 44,903 shares representing earnings after that date.

The defendant in error owned 2,200 shares of the original stock which had an actual value, on March 1, 1913, of $310,200 which, by reason of subsequent earnings had, on January 1, 1916, been increased to

$418,000. After the dividend, she had the original 2,200 shares to which had been added 902 shares, making 3,102 shares of the total par value of $310,200, the exact value of her investment on March 1, 1913. In addition, she had 198 shares of the par value of $19,800 which was her share of that portion of the earnings accruing after March 1, 1913, which the company had distributed or readjusted.

The actual value of both her original and her new shares was more than par because the company still had undivided profits in excess of $20,000,000.00. But what was actually capitalized or distributed in the form of capital was an amount equal to the par value of the new shares. Hence the tax in question was assessed only on defendant in error's share of the gains accruing after March 1, 1913, which were distributed by means of a stock dividend, or on the par value of 198 shares.

BRIEF.

The fundamental and controlling fact is that defendant in error is richer than she was on March 1, 1913, to the extent of 198 shares of Standard Oil stock which actually and in truth constitute a gain which she has derived from capital.

On March 1, 1913, defendant in error owned 2,200 shares of stock of the par value of $220,000 which, on account of undivided profits, were, in fact, worth $310,200. In 1916 she received her share of these undivided profits in the form of 902 shares of new stock. She then had 3,102 shares of stock representing exactly the value of her investment as it stood on March 1, 1913, and the earnings accruing after

that date remained undivided. Enough of the latter earnings were then converted into stock to give her an additional 198 shares. These 198 shares are hers solely because, after March 1, 1913, the corporation caused her capital to earn $19,800. And it is only this amount which she has been required to treat as taxable income.

The outstanding fact upon which the Government rests its right to the tax in question cannot be gainsaid. *It is that, to the extent of $19,800, defendant in error is richer than she was on March 1, 1913, and this increase in wealth is actually and in truth a gain which she has derived from capital.* And since the income which Congress may tax consists of "the gain derived from capital, from labor, or from both combined", this is the fundamental and controlling fact in the case. (*Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415; *Doyle* v. *Mitchell*, 247 U. S. 183, 185.)

Defendant in error's gains, received in the form of additional shares of stock, were properly taxed as income unless Congress either is without the power or has not expressed the purpose to tax this particular species of gains.

Since there is no denying the fact that defendant in error has derived, from her capital, gains which she has received in the form of additional shares of stock, and since, in general, all gains derived from capital are taxable as income, it follows that she was properly taxed, unless it can be said that Congress either has not the *power* to tax such gains in this form or has not expressed a *purpose* to do so.

The ultimate object of corporate business is gain to the stockholders. This gain always and necessarily first appears in the shape of undivided profits which are held in trust for the stockholders. When, later, dividends are declared, the cash or stock received by a stockholder is the same gain converted into a concrete form for the convenient payment, transfer, or definite assignment to him of his share of the previously undivided profits.

The relation of a stockholder to the corporation and to its assets is well understood. The money invested in corporate stock becomes, it is true, the property of the corporation, and the investor ceases to own or control it, save as he may exert an influence over corporate management. Instead of being the owner of so much money, he becomes the *legal* owner of a corresponding amount of corporate stock and thereby the *equitable* owner of an aliquot part of the net wealth of the corporation. The business, however, is the business of the stockholders, though, through the machinery of corporate organization, conducted for them by trustees. Its ultimate object is gain to the stockholders. The invested capital of the stockholder is none the less his because held in trust for him by the corporation. And when, from the use of his capital so held, profits accrue, they are his in the same sense. (*Lynch* v. *Turrish*, 247 U. S. 221, 228; *Collector* v. *Hubbard*, 12 Wall. 1.)

A stockholder can derive gain from his investment only through the earning of profits by the corporation. And it is equally impossible for the corporation to

earn net profits without conferring a benefit, a gain, upon him. Whatever technical and legal distinctions may be attempted, as language is ordinarily understood, a stockholder *gains* whenever earnings or profits accrue to a corporation. This gain is precisely the same in whatever form his aliquot part of earnings and profits reaches him or is held for him. It necessarily is either held for him or reaches him in one of three forms:

1. It may be held for him by the corporation as undivided profits, when it will manifest itself in the increased value of his stock.

2. It may be paid to him in money or property as a dividend.

3. It may be transferred or assigned to him in stock issued as a dividend.

Undivided profits are the form which a stockholder's gains derived from corporate earnings first assume. There can be no dividends until there have first been undivided profits. Dividends are merely the form which the corporation causes these gains or undivided profits to assume to facilitate their convenient transfer to those for whom they have been earned. Defendant in error agrees that such gains, when paid in cash or property, are taxable income, says there is a "serious question" as to whether they can be treated as stockholder's income while undivided, and thinks there is some magic in stock dividends which entirely removes them from the realm of the taxing power.

The power to tax such gains, when distributed in cash, being admitted, the only inquiry is as to the power to tax these same gains while held in trust for the stockholder as undivided profits or when transferred or assigned to him in the form of additional stock.

The power of Congress to tax, as stockholder's income, shares of undivided corporate profits has long been a closed question in this court.

The brief for defendant in error does little more than suggest a *doubt* as to the power to tax, as stockholder's income, shares of undivided corporate profits. And this court has apparently never entertained the slightest doubt on that subject. It held years ago that the power did exist, and, both before and after the Pollock case, has consistently recognized the soundness of that holding. (*The Collector* v. *Hubbard*, 12 Wall., 1, 17; *Bailey* v. *Railroad*, 22 Wall., 604, 635, 636; *Southern Pacific Co.* v. *Lowe*, 247 U. S., 330, 336; *Lynch* v. *Turrish*, 247 U. S., 221, 228; *Lynch* v. *Hornby*, 247 U. S., 339, 343.)

This question of power is discussed in the original brief for the Government at pages 8–14, and further discussion is not now deemed necessary.

Clearly, it must be regarded as settled that a stockholder's share in the undivided earnings and profits of a corporation is within the power of Congress to tax as a part of his income.

Equally with cash dividends, and in every essential sense, stock received as a dividend is merely one of the concrete forms in which a stockholder receives gains previously held in trust for him as undivided profits, and is income within the taxing power.

The right to tax gains derived from a corporate investment when distributed by a cash dividend being admitted, and the right to tax shares in them while held by the corporation as undivided profits having been settled by this court, there can be, it is submitted, no sound reason for saying that stock dividends, the only other form which it is possible for such gains to assume, are excluded from the same taxing power.

1. The Government is under no delusions as to the nature of a stock dividend, or as to what it accomplishes. It serves to readjust the evidence of ownership by which the stockholder previously held his share of both capital and undivided profits. His share of profits are invested for him in the stock of the company. The profits are segregated from his former capital and he has a separate certificate representing his invested profits or gains. It is, of course, conceded that this transaction does not, of itself, make the stockholder richer than he was before. The Government readily agrees that there has been a mere change in form of that which already belonged to the stockholder and that what was not income before is not income after a stock dividend. But this contention of defendant in error proves too much and destroys her case. Her share of undivided profits which has,

by undergoing a mere change of form, become 198 shares of stock, was itself *income* within the power of Congress to tax. Unless its *change of form* destroyed its previous character it was still income. It is defendant in error and not the Government who must rely upon the change of form for success in this case. The Government claims the right to tax gains when wearing a new dress only when they were taxable in their old dress. The defendant in error's contention can not succeed unless the new dress destroys the power to tax which existed before it was put on.

2. Any thing of value, when it represents an actual gain, is income and nothing is income which does not represent a gain. Indeed there is no concrete thing which is always and for all purposes *capital* or always *income*. There is nothing of value which can not be either capital or income according as it does or does not represent or measure a gain. Money is capital and property is invested capital. Money or property when received as a gain is income. Immediately upon its receipt it becomes the capital of him who receives it. What defendant in error actually received was 198 shares of valuable stock. It became, of course, a part of her capital. But the question is, did she derive this addition to her capital from capital previously invested?

3. Defendant in error has undeniably derived gains from her investment in corporate stocks. She has received these gains in the shape of 198 shares of valuable stock. These shares have the same value

they would have had if purchased in the market. If another corporation should purchase them and distribute them among its own stockholders, they would be income of those receiving them. (*Peabody* v. *Eisner*, 247 U. S. 347.) The principle is precisely the same when the corporation invests its earnings in shares of its own stock and distributes these among its stockholders.

4. The *mere* receipt of money or property does not stamp it as income. Whether it is income or not can not be determined without an inquiry into the source from which it has been derived. It may be received as a mere conversion of property from one form to another, and, so far from being a gain of any kind, may involve an actual loss. In other words, what is accomplished by such receipt may be the realization of gains previously accrued, or it may be a return of capital. In any case, when money or property reaches him who receives it, it is immediately a part of his capital. But whether this part of his capital is taxable income depends entirely upon whether it has come to him as the measure of the earnings of his capital or his labor. The question is always, how did he get it?

5. There is no magic in the word *dividend* which makes it, or the money or stock issued under it, any more than money or property acquired in other ways, always and for all purposes, "in its nature," either income or a return of capital. If *money* is paid as the result of a dividend or the distribution of corporate assets it may or may not

be income. If the dividend has been resorted to for the purpose of distributing assets, including no profits, upon the winding up of the corporation, or for the purpose of returning to stockholders a portion of their capital upon an authorized reduction of the capital, the money received by stockholders is not income. (*Lynch* v. *Turrish*, 247 U. S. 221.) But where the purpose and effect is to distribute or assign to stockholders earnings or profits, that which is received by stockholders, whether in money or its equivalent in property, such as stocks of other corporations, is income. (*Lynch* v. *Hornby*, 247 U. S. 339; *Peabody* v. *Eisner*, 247 U. S. 347.) When money received as dividends, therefore, is income, it is not because it is money nor yet because it is paid as a dividend, but solely because it has come to the stockholder as the earnings of his capital, because it serves to transfer or assign to him his share of corporate earnings, and not merely to return some part of his capital.

6. So far as what they serve to transfer or assign to stockholders is concerned, there are but two points of difference between cash dividends and stock dividends.

By a *cash* dividend, a corporation transfers to a stockholder his share of corporate earnings in money, while, in the case of a *stock* dividend, it first invests the earnings in its business and then issues to each stockholder new shares of stock of the same par value as his share of the earnings or, to use other words, invests each stockholder's share of the

earnings in its own stock at par and delivers to him the stock so purchased. In either case, he simply gets, in a concrete form, the actual gains he has derived from his invested capital.

The other point of difference is that a *cash* dividend may serve either to distribute profits or return capital. A *stock* dividend, on the other hand, never contemplates a *reduction* in capital but, on the contrary, necessarily implies an *increase* in capital to be represented by the new shares. It can never, therefore, serve to return capital but that which, in the form of new stock, it assigns to each stockholder is always a share of corporate earnings or gains. In other words, a *cash* dividend may or may not distribute gains, but a *stock* dividend can not, under any circumstances, distribute, assign, or transfer anything else. A *cash* dividend distributes sometimes gains and sometimes capital. A bona fide *stock* dividend always distributes gains.

If the constitutional power exists to tax corporate earnings when they are passed to the stockholder by means of a *cash* dividend, no reason is perceived why the same power does not exist to tax the same earnings when they are passed to him, in an equally concrete form, by means of a *stock* dividend.

Stock issued as a dividend is property in every sense that any other thing of value is property. It is property which has been received by a stockholder. The same test that would be applicable to any other species of property received must be applied. To illustrate, Mrs. Macomber has 198 shares of Standard

Oil Company stock which she received as her property, in 1916. From this statement it does not appear whether they constituted a part of her income for that year. If she had bought them in the market, they would clearly have *not* been income. She would merely have converted her cash capital into invested capital, and there would have been no gain. If she had received them as compensation for personal services or in payment of the rental of property, just as clearly they *would be* income, because they would represent the gain derived from her labor or her capital. If she had received them in repayment of a loan previously made which, with accumulated interest, was equal to their value, they would be income only to the extent of the interest so paid. So far as they were received in payment of principal they would be a mere return of capital. So far as they paid interest they would represent a gain derived from capital. All that Mrs. Macomber, in fact, did to acquire these shares was to invest a part of her capital in the stock of the corporation and thereby to turn over to the corporation that much of her money to use for her benefit. She still has her original stock and it is possessed of a value no less than when she acquired it. But she also has 198 new shares. For these she has paid nothing. To acquire them *she* has not labored but *her capital* has. They are hers because the corporation has caused her money to earn $19,800. If the dividend had been paid in cash, she would have had her original stock, undiminished in value, plus $19,800. That sum

would clearly be her gain. As it is, she has her original stock, undiminished in value, plus 198 shares of stock worth $19,800. The same sum still unerringly measures her gain.

8. If an actual taxable gain accrues, it continues to be no less a gain although it may assume a new form or wear a new dress. And it is submitted, with the greatest confidence, that Congress has the clear *power* to treat as income of a stockholder, stock received by way of dividends.

The act of 1916 taxes gains derived from capital invested in corporate stocks, that is, shares of corporate gains or profits. It does not tax dividends per se but merely uses them to indicate the form in which such gains shall be taxed and to mark the time when the tax shall be collected. And, in the case of stock dividends, it uses the stock issued to measure the amount of the gains.

Assuming the *power* of Congress to tax shares of corporate earnings in any of the three forms in which such shares may reach or be held for the stockholder, the next inquiry is whether the tax imposed has been imposed on shares of corporate earnings or upon something else. An examination of the act of 1916 leaves no room for doubt that the subject of taxation which Congress had in mind was *gains derived from investments in corporate earnings accruing after March 1, 1913.*

1. A corporation and its stockholders are separate legal entities. The relation between them is analogous to that of trustee and *cestui que trust* or principal and agent. The corporation is the trustee or agent

of the stockholder to manage and control his capital for the purpose of gain. The power to deal with the corporation as a legal entity and to tax its earnings, as its income, is, of course, undoubted. And if this should be done the power to tax, as stockholder's income, these same profits, when distributed, would still exist. And if Congress had meant to treat dividends as a distinct source of income rather than as a mere change of form of gains already accrued to the stockholder, there would have been no reason why both taxes should not have been imposed. On the other hand, if Congress, looking beyond mere forms and technicalities, regarded all corporate earnings, whether divided or not, as taxable gains of the stockholder, the natural thing to do was to tax these gains either in the hands of the stockholder or in the hands of his trustee or agent, but not in the hands of both. And this is exactly what was done.

A normal tax of 2 per cent was levied on incomes of *individuals* and a like tax upon incomes of *corporations*. But dividends received by individuals from corporations which had paid the tax were excluded from their taxable income. The stockholder received his gains after his trustee had paid the tax and hence was not required to pay it again. This was a simple plan by which the Government collected from a single source and in a single sum the taxes of all the stockholders on their gains. But for the purposes of the additional tax the plan would not work without injustice. That tax was intended to reach large and not small incomes. Congress thought it should not

be imposed on incomes of less than $20,000 and it was not the intention that such incomes should bear the additional burden, as they would be compelled to do if the tax should be laid on the income of stockholders in the hands of their trustee, the corporation. On the other hand, some stockholders enjoy incomes very much in excess of $20,000. The tax they were required to pay ranged from 1 per cent to 13 per cent according to the amount of income. It would, therefore, be impossible to fix a rate of taxation on the income of corporations without taxing one class of incomes which it was not desired to tax and taxing other classes more heavily than was thought proper, or else relieving still another class of a large part of the burden it was intended they should bear. Congress, therefore, did not impose the additional tax on *corporations* at all, but since the stockholder's trustee paid no tax on his earnings, the individual was required to include in his income all gains from corporate investments.

Congress, by thus taxing corporate earnings only once but taxing them as income of either the corporation or the stockholders, as convenience dictated, has in the clearest manner evinced the purpose to treat, as the actual and ultimate subject of taxation, *corporate gains regardless of the form they may assume.*

2. The same purpose runs through the entire act. The tax is levied upon net income derived from "all sources" which, as has been seen, includes shares of corporate profits, divided or undivided. And, in defining net income, for the purpose of the additional

tax, it is provided that income derived from "dividends on capital stock or from the net earnings of corporations" shall not be included. But dividends themselves are derived from and made possible by earnings. The clear implication is that all gains derived from the *net earnings of a corporation shall be taxed.*

3. The purpose to impose the additional tax on all corporate earnings, except such as the reasonable needs of the business require to be kept undivided, is manifest. They are taxed not only when distributed but equally when permitted to accumulate beyond the needs of the business.

4. The act does not say that *dividends* shall be included as income but only that "gains, profits, and income" *derived from dividends* shall be so included. In like manner, "gains, profits, and income" *derived from salaries, wages, interest, and rent* are included. It is the *gains* which are taxed. What is received by way of salaries or wages is income because, through the payment of wages or salaries, it is a gain derived from labor. What is received by way of interest or rent is income because, through the payment of interest or rent, a gain derived from capital has been realized. Money or stock received by way of dividends is income because, through the declaration of dividends, gains derived from capital are received in concrete form.

To say that this is a tax on stock dividends *per se* would seem to be a play upon words. It is a tax on shares of corporate gains, and stock dividends are

used only to indicate one of the forms in which such gains shall be taxed, to mark the time when the tax shall be collected, and to measure the taxable value.

The tax is not laid annually on a stockholder's share of corporate earnings as they accrue. This species of gains is taxed when distributed by means of a cash or stock dividend, and then the tax for a single year is laid on all such gains so distributed, provided they have accrued since March 1, 1913. The taxable period for corporate earnings, therefore, begins with March 1, 1913, and ends with the declaration of a dividend.

Commenting on a statement in the Government's brief that stock dividends are income whenever they, in fact, represent an actual gain to the stockholder during the *taxable period*, counsel have said:

> The Government seems to think that because the sixteenth amendment went into effect March 1, 1913, or shortly before that, any succeeding period of years is "the taxable period".

It is then asserted that both the act of 1913 and that of 1916 have their distinct and separate taxable periods, each calendar year being such a period. From this it is argued that whatever remains of undivided profits at the end of each year becomes capital and can not be treated as income accruing or received in any succeeding year.

This argument wholly misconceives the meaning both of the Government's contention and of the acts of Congress. If Congress had levied an annual tax on the stockholder's share of corporate profits *accruing during each year*, then, of course, no one would say that any part of the profits accruing

during a particular year could be carried forward and treated as income of a succeeding year. But that is not this case. An annual tax is imposed on *net incomes received.* But this tax is not permitted to attach *annually* to undivided corporate profits. On the contrary, although *accruing,* Congress refrains from taxing them until *distributed,* or, in other words, treats no part of them as *received,* within the meaning of the act, until there has been a distribution. The result is that, instead of an *annual tax on accruing profits,* we have a *single tax on accumulated profits* levied when they are distributed. As a tax could not have been levied, without apportionment, on such accruing profits prior to March 1, 1913, Congress evidently felt that profits accrued before that date ought not, even if they could, be taxed directly or indirectly when afterwards distributed. It, therefore, limited the tax to dividends declared out of earnings accruing subsequent to that date. The result is that the taxable period for such gains as are received in the form of dividends begins with March 1, 1913, and ends with the receipt by the stockholder of the dividend.

The substance of the act of 1916 is that no corporate earnings are taxed as distributed gains which might not have been taxed as undivided profits when they accrued, and all such earnings which might have been taxed as undivided profits are taxed when distributed.

It is, of course, conceded that prior to the effective date of the sixteenth amendment, about March 1, 1913, a stockholder's share of undivided earnings

of a corporation could not be taxed without apportionment among the States. And it is likewise conceded that such earnings as had accrued before that date could not, as undivided profits, afterwards be taxed as stockholder's income.

The act of 1913 taxed income derived from "dividends" but did not define dividends or make their taxability depend upon the time when the earnings accrued. Under that act it was held that taxable dividends were only such as served to *distribute profits* as distinguished from merely *returning* capital, but that the nature of dividends which did distribute profits in money or property was such that they could be treated as distinct items of income without regard to whether the earnings accrued before or after March 1, 1913. It was also decided that the nature of stock dividends was not such that they could, of themselves, be treated as a distinct item of income, and hence that they could not be taxed when declared out of earnings accruing before March 1, 1913. What this court has not had occasion to decide is whether, under the act of 1913, stock dividends, though not themselves distinct items of income, were nevertheless taxable when they served to distribute earnings which accrued after March 1, 1913, and which were, therefore, themselves within the taxing power of Congress.

The act of 1916 puts a different aspect on the question. It defines dividends as including both cash and stock dividends but only when they are declared out of earnings which have accrued since March 1,

2. An assurance that a declaration of dividends would in the future specifically take account of this surplus and be declared upon it.

3. A muniment of title which enables the stockholder to deal easily with his interest in the surplus by a mere assignment of his new stock. (245 U. S. 422-423.)

These were the specific grounds upon which the right to treat stock dividends as income was rested, for, after enumerating them, the Solicitor General said:

> These advantages constitute "income" to the stockholder because they flow to him from his property rights (i. e., "capital") in the corporation, and are capable of easy, accurate monetary appraisement. (Id.)

And further pressing the argument:

> It can not be said that the corporation lost nothing or that the stockholder gained nothing. The former lost its plenary control over the surplus; instead of being indebted to "surplus," with a consequent free use of such funds, it became indebted to "capital," with a limited use of the funds. The latter gained direct right against the corporation instead of an indirect interest in the "surplus." (Id.)

The controversy was thus narrowed to the single question, whether there was anything in the nature of a stock dividend which, without more, made it income, that is whether the mere declaration of a stock dividend conferred such advantages upon the stockholder as to render the dividend an item of

taxable income. Obviously, the court so understood, for, in the opinion, it was to this question alone that Mr. Justice Holmes addressed himself. Viewed in this light, nothing that was said militates against the Government's contention in the present case. It was said that:

> We can not doubt that the dividend was capital as well for the purposes of the Income-Tax Law as for distribution between tenant for life and remainderman. What was said by this court upon the latter question is equally true for the former. (245 U. S. 426.)

It will be observed that it was not said that *no stock* dividend can be income, but only that "the" dividend (that is, the one before the court which distributed profits accruing before January 1, 1913) was capital as well for purposes of taxation as for distribution between life tenant and remainderman. As applied to a case in which the right to tax depends upon the *mere declaration of the dividend* and not upon any facts standing behind that act, no fault can be found with this or with the statement quoted from *Gibbons* v. *Mahon*, 136 U. S. 549, 559:

> A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased * * * and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together

Under that act, the Government comes with this case and asks that a stock dividend declared out of earnings accrued since March 1, 1913, be included as a part of the taxable income of the stockholder receiving it, and in support of its claim says:

> 1. The law does not tax dividends of any kind because they are dividends, but only because they are, in convenient concrete form, gains which have, in fact accrued to the stockholder from capital and mark the time or stage at which Congress has enacted shares of corporate profits shall be taxable.
>
> 2. The purpose to lay the tax directly upon shares of corporate profits is obvious from the fact that, in different contingencies, it is to attach to every form in which it is possible for such profits to inure to the benefit of the stockholder, namely, undivided profits, ordinary or cash dividends, and stock dividends.
>
> 3. The tax on shares of corporate profits is levied upon condition that one of three things shall happen to them, namely, that (*a*) they shall be permitted to accumulate to evade the tax, (*b*) they shall be distributed by means of a cash dividend, or (*c*) they shall be transferred or assigned to stockholders by means of a stock dividend.

Since the power to tax shares of corporate profits, divided or undivided, can not be successfully challenged, these positions, in no way, conflict with *Towne* v. *Eisner*, are supported by reason and authority, and fully justify the tax claimed in this case. Indeed, the defendant in error now, in effect,

takes the same position which the Government took and the court rejected in *Towne* v. *Eisner*. Dealing with gains which had accrued before March 1, 1913, and hence were not taxable as undivided profits, the Government endeavored unsuccessfully to maintain that there was something in the nature of a stock dividend which could convert nontaxable capital into taxable gains. Dealing now with gains which were taxable as undivided profits, defendant in error is forced to contend that there is something in the nature of stock dividends which can convert taxable gains into nontaxable capital. The Government failed because a stock dividend is a mere change of form and does not affect the taxability of that whose form it changes. The defendant in error must fail for the same reason.

When a stock dividend is declared the stockholder realizes on his gains just as substantially and in the same way as when a cash dividend is declared and, as is frequently done, he immediately uses the money received to purchase new stock issued by the company.

There can scarcely be any difference in principle between this and the case in which stockholders use the money received as cash dividends to purchase of the corporation additional stock. In the latter case, the tax is not imposed on the new stock but on the money which represents a share in corporate earnings. In the former case, the stock issued in payment of a stock dividend is not taxed as such. It merely furnishes evidence of the value of a share in corporate earnings which is taxed.

The identity, in principle, of the two cases is well illustrated by the method resorted to sometimes for accomplishing the same purposes that are accomplished by declaring stock dividends. In Missouri and some other States, and under the National Banking laws, statutory provisions are construed to prevent the issuance of stock in payment of dividends. In those States the same result is obtained by the corporation declaring and paying a cash dividend and the stockholders, having previously subscribed for the new stock, paying for it with the money received as dividends. Can it be supposed, for a moment, that the stockholder, in one State, who has received a stock dividend has, in fact, *gained* any less than a stockholder, in another State, who has received a dividend of the same amount in cash and immediately used it, pursuant to a previous agreement, to acquire additional stock?

Reply to arguments on behalf of defendant in error.

It is believed that a complete answer to the arguments advanced on behalf of defendant in error is to be found in what has already been said. But a more specific reply to some of these arguments will now be attempted.

A stock dividend, while it does not cause the corporation to part with any of its assets, does segregate the stockholder's share of profits from his capital and gives him something of value which is derived from his invested capital.

The argument of counsel seems to be based on the idea that there can be no income to the stockholder unless and until the corporation parts with some of

its assets. But the question is not whether the corporation has lost anything, but whether the stockholder has gained anything? When he receives a cash dividend the money is income, not because the corporation has parted with it and not merely because he has received it but because he has received it *as the fruit of an investment* previously made. It is taxed because Congress has enacted that his share of corporate profits shall be taxed when it is segregated *in this way*. The important fact is not a segregation from the corporation of some of its assets but, if a segregation of any kind is necessary, it must be of the stockholder's *gains* from his capital. Congress has now, however, by the act of 1916, enacted that the tax shall be collected when the segregation is accomplished by means of a stock dividend. And this is a real segregation. Before a dividend, one certificate is the evidence of a stockholder's ownership of a share of capital and also a share of profits. When he receives a cash dividend the value of his certificate is reduced and the money received measures the gain which his investment has yielded. When he receives a stock dividend, the par value of his *new* certificate measures his *gains*. As the fruit or result of his investment something of value which is distinct from his original capital and distinct from the corporation's ownership of its assets has come to him. And, as applied to the present case, it may be said that there is no very substantial difference between Standard Oil stock and cash.

The fact that a stockholder is no richer immediately after than immediately before a stock dividend is wholly unimportant.

Counsel for defendant in error assert that the fundamental fact is that a stockholder is no richer after than before a dividend. The fact is admitted but its importance is denied. On a given day one owns a certificate of stock which evidences his ownership of an aliquot part of the capital stock plus the same aliquot part of undivided profits amounting to 50 per cent of the capital. The next day, by virtue of a 50 per cent stock dividend, he owns two certificates, which, however, together evidence his ownership of the very same capital and profits. Of course, no one would say that he has, in the meantime, become richer. But neither has one become richer who one day owns a share of stock which, with its accumulated profits, is worth $150, and, on the next day, by virtue of a cash dividend, owns a share of stock worth $100 and has $50 in cash.

The important fact is that, assuming that the 50 per cent profits have been earned since March 1, 1913, he has, in either case, become richer since that date through the earnings of his invested capital. Congress has seen fit to say that these earnings may accumulate free from tax until they are delivered to him either as cash or in stock. His gain comes, not from the declaration of a dividend of any kind, but from what his capital has earned. The only effect of the dividend is to fix the date upon which, under the law, his share of corporate earnings, previously accrued, becomes taxable.

What was held in Lynch v. Hornby and Towne v. Eisner does not conflict with the present contention that the tax of 1916 is laid on corporate earnings in the form of dividends and not merely on dividends per se.

It is said that the divergent opinions in *Lynch* v. *Hornby* and *Towne* v. *Eisner* show that the tax is laid upon dividends *per se* and refute the present contention that the tax is laid upon corporate earnings and that dividends have been selected as a convenient form in which to reach such earnings.

In both of those cases, it was true that the earnings distributed were beyond the power of Congress to tax. It may be said then that *Lynch* v. *Hornby* does hold that, under the act of 1913, *cash* dividends *per se* were taxed. This was because that act contained nothing which limited the tax to dividends declared out of *taxable* profits. But certainly nothing was said which implied a want of power in Congress to impose a tax only on all dividends of whatever kind which, in fact, serve to distribute profits which it *might have taxed while undistributed*, and this, as has been seen, is exactly what the act of 1916 does.

If not included under the term "dividend," stock dividends were excluded from taxation by the act of 1913.

It is said, in effect, that *Towne* v. *Eisner* must be regarded as determining that a stock dividend, in its very nature, can never be treated as income, for otherwise such dividends were taxed by the act of 1913 which embraced "the entire net income arising or accruing from all sources." This language was

used to express the general purpose of the act. It was followed, however, by other language prescribing the manner in which different species of income were to be reported and taxed. A stockholder's share of corporate profits was not required to be reported, unless such profits had been permitted to fraudulently accumulate, until it reaches him in the form of a "dividend." The purpose to exclude from taxation corporate earnings save in one of these two forms was obvious. When, therefore, it was held that stock dividends were not "dividends" within the meaning of the act, the result was that stock issued as dividends merely represented undivided profits, which Congress refrained from taxing, held by a different title and evidenced in a different way. Manifestly, being clearly excluded from the purpose of Congress to tax, they could not have been held to be included in the general language quoted.

As to the taxability of undivided profits, the present case involves no consideration which was not equally involved in Collector v. Hubbard.

Counsel have quoted from the opinion in *Collector* v. *Hubbard* as follows:

> Annual gains and profits, whether divided or not, are property, and, therefore, are taxable.

The argument seems to be that the case turned on the fact that this interest of the stockholders was *property* rather than that it was *income*. The implication is that the court then thought that Congress

had power to levy direct taxes on *personal property* without apportionment and hence, having found that the thing taxed was personal property, did not find it necessary to pursue the inquiry further. But the tax under consideration was, in form and in fact, an income tax and the thing taxed was a share in corporate earnings. The case must, in any view, be authority for the proposition that *property*, such as a share of undivided corporate profits, might be taxed along with income by an act which purported to tax only income. One of two propositions must follow:

1. Such share of undivided profits was held to be income to stockholders as the profits accrued, or

2. Though not income, Congress, having the power to tax it as property, might, under that power, tax it along with income and by an act which purported to tax nothing but income.

The first proposition would be conclusive of the case. The second would sustain the tax as an excise tax on the privilege of receiving dividends even though it could not be sustained as an income tax.

The tax is imposed upon shares of corporate earnings, divided or undivided, and the various forms, including stock dividends, in which they shall be taxable, are specified. It is, therefore, immaterial whether such a dividend be regarded as distributing profits or only readjusting the evidence of their ownership.

An elaborate argument has been indulged to show that the tax in question is not one on *undivided profits*. This, however, is beside the question. It

may be more accurate to speak of a stock dividend as readjusting the evidence of ownership of undivided profits rather than as distributing such profits. But, by specifying the various forms in which corporate earnings shall be taxable, the act clearly expresses the purpose to tax them, *divided or undivided*, according to circumstances. When a stock dividend has been declared, they have either been divided or, of necessity, they remain undivided, though held by a different title. In either event, they have assumed one of the forms in which Congress has said that they shall be taxable.

If any unfairness results from the Government's construction of the law, it is much less than would result from that urged by defendant in error.

It is stated that the Government's construction of the law imputes to Congress the intent to perpetrate a gross inequity. It may be replied that it is impossible to frame any general tax law in which inequalities can not be found. Moreover, what is called a gross inequity, when examined, does not seem so very gross. It is true that a stockholder who has stock of the par value of $1,000 which carries with it a share of undivided profits worth $100 is no richer and has gained no more than another who owns stock of the same par value but has received his profits in the shape of a stock certificate for $100. The suggestion is that it is unjust to tax one and not the other. But no corporation is compelled to declare stock dividends. It is only done when supposed to be, for some reason, an advantage to stockholders.

Otherwise, such part of the profits as it is not thought proper to distribute in cash would be left undivided. If there appears to be enough advantage to stockholders in having their profits in additional stock to justify paying the tax, the corporation may declare a stock dividend; if not, it is at liberty to keep the profits undivided. It is difficult to see any glaring injustice in this. Certainly there is no such injustice as would result from taxing cash dividends and not taxing stock dividends. In that event, one receiving $1,000 in cash would pay a tax, while one who received a stock certificate which could be immediately converted into $1,000 would go free.

The general plan seems to be a fair one. None are required to treat as income corporate earnings so long as they remain undisturbed in the hands of the corporation. Those who receive them from the corporation in cash or stock, in money or invested capital, must treat as income the value of what they receive.

By not imposing an annual tax on accruing corporate profits, Congress has not withdrawn for all time the hand that gathers taxes from such profits accruing during a particular year. It has merely stayed that hand until the happening of a named contingency—a distribution of accumulated profits.

Conclusion.

It is clear that Congress has the power to tax, against stockholders, shares of corporate profits when they take the form of stock dividends; that the pur-

pose to do this has been expressed in unmistakable language; that the tax now in question is clearly within the terms of the law; and that the judgment of the district court denying the Government's right to collect it should be reversed.

Respectfully,

WILLIAM L. FRIERSON,
Assistant Attorney General.

SEPTEMBER, 1919.

○

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OCT 13 1919
JAMES D. MAHER,
CLERK

No. 318

IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1919.

MARK EISNER, COLLECTOR, ETC.,
Plaintiff-in-Error,

against

MYRTLE H. MACOMBER,
Defendant-in-Error.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

Motion for Leave to File a Brief and Argument, and Brief of Argument of George W. Wickersham and Charles Robinson Smith as *Amici Curiae* in Support of Judgment Below.

GEORGE W. WICKERSHAM,
CHARLES ROBINSON SMITH,
as Amici Curiae.

The Dispatch Printery & Bindery Corporation
New York

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III. The stock dividend is in reality not a dividend at all. It is a mere certified expression of an undivided surplus and its capitalization. Whatsoever gain there may be in either case to the stockholder is a capital gain. Capital gains (being mere increases in valuation) are not income until realized. The gains that come with stock dividends when stock is sold are realized capital gains—the same in nature and similarly taxable as those gains that are made with any stock that is sold at an advance. Inasmuch as undivided corporate earnings cannot be taxed as income against the stockholder—so the stock certificates issued merely to represent these may not be so taxed, until the gain be realized in some form by sale 60

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IN THE

Supreme Court of the United States,

OCTOBER TERM, A. D. 1919.

No. 318.

MARK EISNER, COLLECTOR OF UNITED STATES INTERNAL REVENUE FOR THE THIRD DISTRICT OF THE STATE OF NEW YORK,

PLAINTIFF-IN-ERROR,

AGAINST

MYRTLE H. MACOMBER,

DEFENDANT-IN-ERROR.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

Motion for Leave to File a Brief and Argument, and Brief of Argument of George W. Wickersham and Charles Robinson Smith as Amici Curiae in Support of Judgment Below.

Motion.

Now come George W. Wickersham and Charles Robinson Smith, attorneys and counsellors of this Court, and represent that there is involved in the above mentioned case a question of whether or not,

under the Sixteenth Amendment of the Constitution of the United States, Congress is empowered to impose an income tax upon stock dividends of a corporation issued with respect of profits of such corporation accumulated since March 1st, 1913, upon the issue of such stock dividends and before sale thereof by the stockholder;

That this is a question which vitally affects the interests of a number of their clients who would be adversely affected by a decision affirming the position taken by the Government in this case.

Therefore, they pray leave to file a brief and argument as *amici curiae* in support of the affirmance of the judgment of the Court below; such brief and argument being as follows:

Statement.

The facts are set forth in the statement of the case in the Brief and Argument for defendant-in-error, submitted by the Honorable CHARLES E. HUGHES and GEORGE WELWOOD MURRAY.

BRIEF OF ARGUMENT.

The Government seeks to distinguish this case from the decision in *Towne* v. *Eisner,* 245 U. S., 418, upon the ground that the stock dividends there under consideration were issued with respect of profits of the corporation earned and accumulated prior to March 1, 1913, whereas here the tax was levied upon an amount of the stock dividend equal at par value to the aggregate accrued profits of the corporation earned since March 1, 1913. The argument is, that all earnings of a corporation constitute income belonging to or held in trust for its stockholders, and are subject to the constitutional

power to tax incomes, which may be exercised as Congress shall elect, by imposing the tax wholly or in part upon the corporation, or wholly or in part upon the stockholders.

This argument brushes aside the separate corporate entity, treats corporate enterprise as a mere partnership, and thus establishes the plenary authority of the taxing power over the aggregate corporate gains, irrespective of whether or not the stockholders actually may have received or enjoyed any share in them. It is claimed that this position is supported by the decision of this Court in *Collector* v. *Hubbard,* 12 Wall., 1.

The Act of Congress of 1916 (39 Stat., 756, Sec. 2a), in imposing an annual tax upon the net income of a taxable person derived, *i. a.,* from dividends, provides that the term "dividends", as used in the act,

> "shall be held to mean any distribution made or ordered to be made by a corporation * * * out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation * * *, which stock dividend shall be considered income, to the amount of its cash value."

To bring a dividend within this definition, it must appear

(1) that the corporation has made or ordered a *distribution* out of its earnings or profits accrued since March 1, 1913;

(2) that such *distribution* is made payable to its stockholders, including the person taxed;

(3) that such *distribution* is payable in cash or in stock which has a cash value.

But a stock dividend, pure and simple, such as that made by the Standard Oil Company of California in the instant case, is not a *distribution* of anything. It is a mere *readjustment* of the evidences of the shareholders' interest in the corporation. The issue of certificates for shares under these circumstances is not *payment* of any earnings or profits. The provisions of the statute are not applicable to such an issue.

The Government concedes the facts, but disputes the conclusion. The Assistant Attorney General in his supplemental brief (at p. 15) says:

> "The government is under no delusions as to the nature of a stock dividend, or as to what it accomplishes. It serves to readjust the evidence of ownership by which the stockholder previously held his share of both capital and undivided profits. * * * The Government readily agrees that there has been a mere change in form of that which already belonged to the stockholder and that what was not income before is not income after a stock dividend."

It is sought to avoid the effect of this concession by the argument; that the income of *the corporation* is also the income of the stockholder; that the issue of a stock dividend distributes that income to the stockholder and that the government, which could tax the income as it accrues either against the corporation or the stockholder, acts within its powers and exercises them with fairness and restraint, when it only imposes the tax at the moment when the stockholder receives a separate stock certificate representing what the government is pleased to call "his invested profits or gains."

We challenge the soundness of this position. It is contrary alike to economic fact and well settled principles of law. We deny that it finds some sup-

port in *Collector* v. *Hubbard,* 12 Wall., 1, but even if it did, we should deem it immaterial. Since the income tax cases of 1894 (*Pollock* v. *Trust Co.,* 157 U. S., 429; 158 U. S., 601), the authority of that case is restricted to direct taxation of property. Considered in its effect upon income, it is overruled by well settled lines of decision.

Moreover, if the Government is correct in its interpretation of the statute, and Congress did attempt to tax the stockholder as the recipient of an amount of income equal to the cash value of the stock issued, even though the same be issued to represent an amount of corporate gain received and accumulated by it in previous years, upon which the corporation itself paid, or is liable to pay the tax imposed upon it, carrying the balance to the credit of surplus account, adding it to its capital, and investing it in its business; then, we submit, Congress has exceeded the constitutional limit of its powers, and in effect has imposed a direct tax upon capital, without apportionment, which may not be justified by calling the capital income, which it is not.

POINTS OF OUR ARGUMENT.

1. The principle laid down by this Court in two well-considered cases (Gibbons v. Mahon, 136 U. S., 549, and Towne v. Eisner, 245 U. S., 418), that stock dividends represent capital and do not constitute income is based on sound economic reasoning.

2. Although the Hubbard case (Collector v. Hubbard, 12 Wallace, 1) is plainly distinguishable from the case at bar, it is nevertheless inconsistent both with other and later rulings of this Court and with sound economics. It tends to block the way to a

consistent, harmonious and logical system of income taxation and it should be expressly overruled.

(a) The Hubbard case as upholding a tax on property or the income from property except by apportionment under Art. I, §2 of the Constitution has been overruled by the Pollock case.

(b) The Hubbard case, insofar as it assumes an equivalency between the property and the income of the corporation and the shares of stock in the names of the stockholders for taxation purposes, has been implicitly overruled by a long series of authorities in this Court.

(c) The suggestion that this Court has in other cases cited Collector v. Hubbard or its principle with approval except upon altogether minor points is erroneous.

3. The stock dividend is in reality not a dividend at all. It is a mere certified expression of an undivided surplus and its capitalization.

Whatsoever gain there may be in either case to the stockholder is a capital gain.

Capital gains (being mere increases in valuation) are not income until realized.

The gains that come with stock dividends when stock is sold are realized capital gains—the same in nature and similarly taxable as those gains that are made with any stock that is sold at an advance. Inasmuch as undivided corporate earnings cannot be taxed as income against the stockholder, so the stock certificates issued with respect of such earnings may not be so taxed, until the gain be realized by the stockholder through sale of his stock.

FIRST POINT.

The principle laid down by this Court in two well-considered cases (*Gibbons v. Mahon* and *Towne v. Eisner*), that stock dividends represent capital and do not constitute income is based on sound economic reasoning.

The question involved here is one of definition—the meaning of the word "income" as used in the Sixteenth Amendment. It is absolutely necessary to define the meaning of that word and its limitations, if the restrictions of the Constitution on the power of taxation are to be respected.

The original provisions of the Constitution as limited by the *Pollock* case and enlarged by the Sixteenth Amendment have now given to Congress definite, broad powers of taxation with definite limitations thereon. It is settled that taxes on land or personal property are direct taxes and cannot be levied except by apportionment. On the other hand, income from whatever source derived, even income from land and personal property, may be taxed by the Federal Government without apportionment.

In applying these powers, it becomes necessary, therefore, to distinguish what is Capital and what is Income. If a stock dividend is taxable under the Revenue Act in question, it must be not because stock dividends are expressly mentioned in this Revenue Act as they are in fact mentioned, but because the term "stock dividends" is really covered by the term "income" in the Sixteenth Amendment—because, in short, stock dividends may be properly defined as income.

Just as a stream cannot rise higher than its source, so the Revenue Act could not include as taxable any items that were not already included in that single word "*Income*" as employed in the Sixteenth Amendment.

Nobody doubts that cash dividends in general are included in this word income. If stock dividends are included, it must be because stock dividends are income. If stock dividends are not dividends, then they certainly are not income. But this Court has twice decided that stock dividends are intrinsically not dividends at all. In *Towne* v. *Eisner*, the Revenue Act of 1913 used language as broad as that of the Sixteenth Amendment. The language of the Sixteenth Amendment is: "Income from whatever source derived." The language of the Act of 1913 is: **"The entire net income arising or accruing from all sources** in preceding calendar year," and yet this Court held that stock dividends were not income within that Act.

In this respect the Court is supported by sound economic reasoning. A consideration of the distinction between Capital and Income will show that this is so; and **as the subject matter of the Sixteenth Amendment was an economic question, it must be assumed in default of plain language to the contrary, that the people in so fundamental a law as a constitutional amendment employed terms in treating it that would be conformable to sound economic principles.**

In a sense, **all capital excepting bare land** was in its origin income. What we now know and recognize as capital was originally wages or salary or profits or rents or interest or return or remuneration of some sort for effort or for the use of previous capital. The whole economic situation is in a state

of flux—a state of change, not a fixed state but a state of becoming, and thus income is continually becoming capital. For purposes of this definition, it is important to fix the time when this occurs, or at least its boundaries, because income that has once become capital can no longer be taxed as income under the Sixteenth Amendment unless we break down all the limitations of the Constitution —all distinction between income and capital—all distinction between income taxes and capital or direct taxes.

There is often no ear-mark to show what items of property or money are income and what capital. A man's wages, his salary, his interest or cash dividends, may be thus ear-marked at the time of their receipt; but in industry, the gross returns indiscriminately include the return or repayment of the capital invested in manufacturing the goods as well as the profits thereon, and in such case a mere adding up of receipts does not show the income of the industry. The greater part of those receipts is capital return. Hence it becomes necessary to keep elaborate accounts and at fixed periods determine that part of the receipts which is the return or restoration of the capital invested in materials and wages, etc., in producing the goods and that part, if any, left over for profits or income. But in either or any case, these returns thus constituting income unless consumed quickly become capital.

What was the income of one year becomes the capital of the next. An income tax, therefore, in order to be a real tax on income must as nearly as possible catch that income whilst it is income or as soon thereafter as the amount of income for the given period can be determined. It is obvious that

no one year's income can be known until after the end of that year and in industry it takes days, weeks and sometimes months after the end of the year to compute what has been that year's income. For this reason, much of the year's income thus open to taxation may have become changed into fixed forms of capital before the tax can even be computed or levied; but that is a difficulty inherent in the income tax, and this difficulty only emphasizes the need in a true income tax, of levying the tax as promptly as possible and before the income to be taxed can have been too largely changed in character.

Time is thus an important element in distinguishing capital from income.

With a tax law known in advance, there will be no difficulty in reserving from the ebb and flow of the year's income enough to pay each year's taxes as they may be computed shortly thereafter.

These considerations lead to the conclusion that the income of any one year should be taxed only once and not at two different times—and especially not in two successive years or tax periods.

To illustrate with a concrete case: We will suppose that a given corporation has paid in 1916 its taxes on all its 1915 income including its surplus for that year. This surplus has become invested in extensions and has then become fixed capital. The corporation gives its stockholders certified proof of this fact by distributing additional shares covering exactly the beneficial interests they had before—no more and no less, certifying however to them the fact that the business has been extended and that some of the Company's income has been made capital. This stock dividend is distributed in 1916 because the earnings of 1915 permitted this capi-

talization of income, but the earnings are 1915 earnings. Now, mark the result. If the stockholder is taxed on this stock dividend, he is in effect made to pay in 1917 as if on 1916 income what was in reality 1915 earnings. And yet, if there be any distinction whatsover between Income and Capital, it is obvious that what was earned as income in 1915 cannot be considered the income of 1916. By that time it has clearly become capital. In this particular case, we have a confirmation that it has become capital, because the fact is so certified to us by this stock dividend which is a way of saying that the company had not the cash to pay a dividend and needed to capitalize these residual profits to extend its business. This certification that income has become capital is certainly not income in itself—no new income. The stockholder is intrinsically no richer the instant after than the instant before the dividend, and the corporation is no poorer, as the Supreme Court several times has said.

So that the Government's contention amounts to this: That this income earned by the corporation in 1915 and subjected to an income tax as soon thereafter as possible in 1916, may still in 1917 be made to pay another income tax as 1916 income just because in that later year it is certified to the stockholder not as income but as capital.

Our analysis thus discloses two conclusive reasons why stock dividends are not income. First: that already emphasized by this Court, that they are like undivided profits—the stockholder is no *richer* than before merely by reason of the stock dividend; and secondly, that at the time when the stock dividends were received, they had ceased to be earnings of the taxable year, having already become capital.

The very fact that Congress in this Revenue Act

found it necessary expressly to specify stock dividends proves that they would not be included in the broad te. *"Dividends";* if they are not included in the term *Dividends,* they certainly are not included in the Sixteenth Amendment, for if stock dividends are income, it must be because they are dividends.

This analysis is in accord with the views and the reasoning of scientific economists.

"Income and capital are therefore two aspects of wealth. In the one case we measure wealth as a flow of services or a stream of satisfactions; in the other case, as a stock of services or a fund of satisfactions. * * * The original conception of income is therefore pleasure or benefit income" ("Principles of Economics," Seligman, 7th Ed., p. 16).

With this ultimate psychological analysis we have, however, little to do in any scheme of taxation which concerns money or money's worth; and so Prof. Seligman adds: "In modern times value has come to be estimated in terms of money and income is accordingly used in general to denote the inflow or revenue in money—the money income as opposed to the pleasure or benefit income." And again, "Capital is capitalized income" (*Id.*, p. 17).

The distinction between income and the accumulation of postponed and deferred income that we call capital is the fundamental distinction in economic life.

"The business man's income means money income" ("The Nature of Capital and Income" by Prof. Irving Fisher, p. 103).

"Income as contrasted with capital denotes that amount of wealth which flows in during a definite period and which is *at the disposal of the owner for purposes of consumption, so that in consuming it,*

his capital remains unimpaired" (Seligman, Income Tax, p. 19).

(See Prof. Seligman's masterly analysis in an article entitled "Are Stocks Dividends Income?" reprinted from the September, 1919, number of the American Economic Review and accompanying main brief in this case.)

No one would be disposed to dispute, but on the contrary all would accept this Court's definition of income as "the gain derived from capital, from labor, or from both combined". But when the Government undertakes to apply this definition to anything of value in whatever form, however inchoate, unrealized and unseparated, which represents a gain derived from capital, labor, or both, to paper gains in fact, the Government is contradicted both by the previous rulings of this Court and by sound economic reasoning.

If gains in general and paper gains may properly be considered income, then this would hold true of mere appreciation in value of real estate or of personal property that is not sold—a gain that is not realized. But this sort of appreciation or gain in capital value can never constitute income within the Sixteenth Amendment. See *Gray* v. *Darlington*, 15 Wallace, 63; the last sentence in *Lynch* v. *Turrish*, 247 U. S., 221, at p. 231; *Baldwin Locomotive Works* v. *McCoach*, 221 Federal, 59, and *Towne* v. *Eisner* (*supra*).

And if a stockholder holds stock in a corporation which has made large earnings that have not been divided, and on which the corporation has paid its income tax, such stockholder has indeed made an unrealized, an inchoate, capital gain and his stock has probably advanced in market price. This increment is perhaps property which might be taxed as such. But can this unrealized gain in his capital

be considered income and taxable as income within the Sixteenth Amendment by any amount of legislation? Certainly not if the distinction is to be preserved between the corporation as one person and the stockholders as distinct persons; nor if the distinction is to be preserved between a gain which is realized and which produces the money to pay an income tax and one which is unrealized and produces no money.

It cannot be doubted that the sort of gain referred to by this Court as constituting income was a realized gain—not the gain of mere appreciation in value.

This appears from an examination of what this Court referred to in the two cases in which it defined the word.

In *Stratton's Independence* v. *Howlett* (231 U. S., 399, 415), the gains thus defined were the profits of a mining company from the mining and sale of coal.

In *Doyle* v. *Mitchell* (247 U. S., 183, 185), the gains in question were the profits from the cutting and sale of timber.

There was evidently nothing inchoate about gains such as those. They were gains that had been realized and "cashed in" and of course they were taxable as income.

This distinction between realized and unrealized gains is of capital importance in the income tax. Unrealized gains are technically inchoate gains and inchoate gains are not income. This does not mean that a gain in capital may not become income. Capital increment becomes income when realized—that is, when cashed; until then, barring a few exceptions alluded to below, it is inchoate. Realized capital increment is income in its widest sense. Unrealized capital increment is not income but

simply an appreciation of capital—no flow of income whatever.

The distinction was well marked by this Court in *Lynch* v. *Hornby* (247 U. S., 339), where it spoke of "accumulated earnings as coming to fruition," and of a *"realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing"* (p. 344).

The same thought is expressed by Mr. Justice Holmes in Towne v. Eisner where he says: "If the sum, [that is, the same amount as the stock dividend] had been carried from surplus to capital account without a corresponding issue of stock certificates, which there was nothing in the nature of things to prevent, we do not suppose that any one would contend that the plaintiff had received an accession to his income." 245 U.S., at p. 426.

When we speak of realization, we usually mean a realization in cash. But this is not always so. A lessor of a farm who receives his rent in produce; the farmer who gathers his harvests and holds them unsold beyond the taxable year; the manufacturing company which makes unsually large sales on credit, which sales are not cashed during the taxable year: all these are cases where realized profits and income are clearly made during the taxable year although they be not cashed in.

But all these, like dividends in kind, are new gains separable from the capital which produced them and they are realized in the possession of, and are under the control of, the recipient—and they can be realized in cash by him without in any way affecting his rights in these respective sources of his income.

The Union Pacific stockholder who received B. &

O. shares as a dividend received a new gain separable from his Union Pacific shares—a gain realized in the concrete form of income producing property and realizable in cash by sale thereof without affecting his investment rights in the Union Pacific (*Peabody* v. *Eisner,* 247 U. S., 347).

But if the Union Pacific had given him a stock dividend instead of this dividend in kind, he would have realized no new gain—he would have had nothing intrinsically new to cash that he did not have before—and if he had sold the new stock he would have parted not with a thing separated from the Union Pacific Company but with a percentage of his former interest in that company itself.

A most important point is the separation of the increment from the capital.

This separation is necessary in order to constitute income. The increment as separated is income. The increment of capital unseparated is capital—whether it be a corporate surplus or a gain in value. From the shareholder's point of view an increase in the surplus of the corporation is precisely like an appreciation in value of real estate or other property holdings—no more, no less.

In another aspect, this separation of income from capital means giving to the stockholder personally control of something he did not have before. Give him a dividend in cash or in tons of coal or in stocks of other companies than his own and he controls something new—may do with it what he please without affecting his interest in his company. Give him a stock dividend and he neither owns nor controls anything new whatsoever, in an intrinsic sense. And let him but sell his stock dividend and he loses control *pro tanto* of that which he had before. He diminishes his beneficial interest in, and percentage of control of his company.

Not so with a real dividend, be it cash or tons of coal or securities in another company. Let him part with these and his interest in his company, the source of this dividend, remains entirely unaffected.

As Prof Seligman says: "Income is that wealth which flows in during a definite period and *which is at the disposal of the owner for purposes of consumption*" (Seligman, Income Tax, p. 19). The gain must be some new thing at the disposal of the owner or it is not income. To illustrate: after a 25 per cent stock dividend on 100 shares of stock, the stockholder has nothing more and nothing intrinsically different to dispose of than before. In either case by selling one-fifth of his holdings he would part with precisely the same interest in the company and its surplus—lose precisely the same degree of control. And in either case, if he holds his stock he holds the same interest, the same undivided earnings, the same control.

Almost all these points of distinction between gains in general and real income are set forth in that one short sentence cited from *Lynch* v. *Hornby* (*supra*). An undivided corporate surplus as regards the stockholder has not yet "come to fruition"; is not yet "realized"; is not "in possession" as regards him. It is on the contrary "inchoate," and it is "contingent"—because its "coming to fruition," being "realized," or coming into his possession, depends on other wills than his—so that he may never receive it. And as a mattter of fact in most cases never will—for in most cases the surplus will have been capitalized—and the stock dividend is but the formal authentication of that fact.

An undivided corporate surplus, therefore, which the corporation has set aside for extensions and

virtually capitalized, lacks the very essense of income from the stockholder's point of view. It is as little income and as much capital as is the increase in value of one's unsold real estate.

It is believed that no country in the world has ever attempted to tax a shareholder because of an increase in the surplus of a corporation (if exception be made of Chap. 173 of the Laws of 1864, which since the *Pollock* case to be discussed later, would now be deemed unconstitutional—see below).

Whenever a corporation has made substantial earnings, three courses are open to it: It may either declare a cash dividend, or it may merely increase its surplus, or it may distribute a so-called stock dividend.

In the case of the cash dividend, the new increment is a realized gain, separated from the company's assets, and is income. In the case of the increase in surplus, the unrealized gain is not income and no money is furnished to pay an income tax unless some of the stock is sold. In the case of the stock dividend, the new increment is not a realized gain and it is not income and, as in the preceding case, no income is produced to pay an income tax unless some of the stock is sold. "The stock dividend is like an increased surplus—it is not like a cash dividend. In fact, a stock dividend is not a dividend at all in the sense in which a cash dividend is a dividend. The entire confusion really arises from a misnomer." (Seligman's article, *supra*, p. 534).

In the case of the cash dividend, the corporation in the first instance had made its profits on which it is liable to an income tax, and it has taken a part of those profits from its own assets and given them to the stockholder as a realized gain to him on which he too is liable to an income tax.

On the other hand, the case of the undivided surplus and the case of the so-called stock dividend are intrinsically similar, in that what was a gain to the corporation on which it has paid an income tax has become capital; and whether it stands as a surplus or stands as officially capitalized by stock certificates, in neither case is it a realized gain to the stockholder. Nor in either case has the corporation parted with anything.

But, where a dividend is made in kind—that is in property or in shares or securities of another corporation, the company does part with some of its own assets and give its stockholders dominion over them. These assets are not invested as capital in the Company's business; they constitute a real gain to the stockholder over what he had before. And if he sell the items received in order to pay his income tax, he does not part with any interest in or control over his corporation, as he would do if he sold his stock dividend shares. Real dividends transfer to stockholders property which previously belonged to the corporation. Stock dividends do not do this. The situation both of the Company and of the stockholders is intrinsically the same just after, as just before, a stock dividend.

On the former hearing of this case, the Government argued in effect that a stock dividend is similar to a dividend in the stock of another corporation —although this Court had distinctly said the contrary in *Peabody* v. *Eisner,* 247 U. S., 347. "It hardly is necessary to say that this case is not ruled by our decision in *Towne* v. *Eisner,* since the dividend of B. & O. shares was not a stock dividend but a distribution *in specie* of a portion of the assets of the Union Pacific, and is to be governed for all present purposes by the same rule applicable to the distribution of a like value in money" (p. 349).

Of course, the stock dividend like the dividend in kind would affect or reduce the previous book value of outstanding shares of stock; but it would *reduce them by dilution.* The dividend in kind *reduces them by subtraction.* And the stock dividend would not reduce the corporation's assets and it would not increase the stockholder's assets—as would the dividend in kind or in another company's stock or in cash. The stock dividend takes nothing from the company and consequently gives nothing to the stockholder that he did not have before. Not so the dividend in cash or in the stock of another corporation. The corporation here parts with some of its assets. The stockholder becomes *pro tanto* sole owner of these. He has a new power of disposition and a control that he did not have before.

The dividend in kind in the stock of another company if sold involves no parting with assets essential to the original company or still belonging to it, and above all it involves no sacrifice of or change in voting control—no change whatever in the stockholder's investment in the business or in his percentage of future dividends and earnings.

The time may come, however, when the stockholder will realize on his inchoate gains. He may sell his stock. In fact, he is almost certain to do so at some time or another; and when this happens, the increased value imparted to his total holdings, whether through the surplus or the stock dividend, will show itself in the enhanced price received, and he will have to pay a tax on the profit. But at that time he will be cashing in his profit and will be perfectly able to pay the tax out of that particular income instead, perhaps, of being forced to sell capital or borrow money in order to pay a so-called income tax which would not be a tax on income.

A very interesting discussion of this subject from

the economic point of view has been published in Vol. III of the Bulletin of the National Tax Association, April-June, 1918. At page 161 is an article on *"The Economic Nature of the Stock Dividend"* by Prof. Fred. Rogers Fairchild, Professor of Political Economy at Yale University: at page 237, a reply thereto by Henry H. Bond, State Income Tax Deputy, at Boston, Mass., in an article entitled "A Practical Aspect of the Stock Dividend Question"; and on page 240 another article by Prof. Fairchild entitled "The Stock Dividend—a Rejoinder."

Below are some quotations from Prof. Fairchild's articles:

> **"It is unfortunate that the term 'dividend' was ever used in this sense. The 'stock dividend' is really not a dividend at all, but merely a bookkeeping change in the liability of the corporation to its stockholders. Were it not for this unfortunate use of terms, the common notion that a stock dividend is income, like a cash dividend, would probably never have occurred to anyone."**

Again:

> "The inclination to regard a stock dividend as income may sometimes be traced back to the notion that an increase in the value of capital is income. This fundamental error has been the cause of much confusion. Let us see exactly what is the relation between capital and income. Capital is a fund or stock of wealth in existence at a given time. Income is the flow of services or benefits of capital during a period of time. * * * Income must not be confused with growth of the capital."

* * * * * * * *

> **"The Supreme Court, in deciding that a stock dividend is not income, was therefore following sound economic principle."**

> * * * "it is worthy of note that some of the most serious errors in our tax legislation have been due to confusion as to the true nature of capital and income and their relation to each other. The clear-cut decision of the Supreme Court as to the stock dividend was greatly needed."

At page 242:

> **"Whether the dividend is paid in cash, in stocks of other companies, in tons of coal, or anything else, so long as something is taken from the corporation's assets and given to the stockholders, the latter have received income from the corporation. The pro rata distribution of new shares of the corporation's own stock does not do this. * * *"**
>
> "The whole difference between the cash dividend and the other cases (those referred to by Mr. Bond) is that in the first the value of the shareholder's capital represented by the stock has been reduced and income has been received, whereas in the two other cases there has been no such reduction of capital and no income."

Mr. Bond's article at page 237 is scarcely occupied with a real analysis of the subject or the intrinsic merits of the question, but rather with citing examples of well known companies that have declared stock dividends where the shares subsequently rose greatly in value, and deducing from these particular facts the general conclusion that the total market values of the stockholder's holdings invariably rise on the declaration of a stock dividend, and that therefore the stock dividend constitutes income.

But it is a fallacious argument in support of the taxation of stock dividends that the total value of a stockholder's unsold holdings is often raised thereby in market value.

Shares also rise when a company's report shows that it has recently made large surplus earnings. Are these too income to the stockholders even though not distributed?

Mr. Bond admits that they are not, for he says: "It (*income*) is not received by a stockholder when merely added to corporate surplus." If this be correct, and we submit that it is, this shows that the market value of unsold shares has nothing to do with the case,—any more than a rise in the market value of one's real estate or of a herd of cattle.

And cases are numerous where shares of stock decline in value on the declaration of a stock dividend—so that the aggregate market value may be less than before. Is such a stock dividend nevertheless income also, although it represent a capital loss?

The truth is that the only bearing of market value is as and when the stockholder elects to sell a part of his stock. Then it is that market value determines whether his stock dividend represents a realized gain and therefore income or a realized loss. To make this fallacy clearer, let us consider the converse of a stock dividend.

Suppose a company has sustained losses impairing its capital 50 per cent. and that it reduces its capital stock accordingly—stockholders now being compelled to give up 50 per cent. of their old stock. Is this a loss that may be deducted from their other income? Manifestly not, because it is not a realized loss. They continue to retain their same proportionate interests in the company. The company may recoup that loss later. They are at liberty to sell their stock and realize their loss at once and deduct it. But so long as they hold their stock, such a loss is but an inchoate loss, a potential loss, an unrealized loss, an unseparated loss, and one that

in fact ultimately may never turn out to be a real loss at all.

This antithesis between a plus stock dividend and a minus stock dividend makes it clear that corporate gains and corporate losses even though they be represented by an increase or decrease of capital stock and even though they be accompanied by changes in market value are not income gains or income losses of the shareholder.

In sound economics this is so, and in law this is so too, if we are to uphold the rule upon which all our vast system of corporate enterprise is founded —that rule, or legal fiction, which regards the corporation as an entity distinct from its shareholders.

We may freely admit that as a general rule the stock of a well-managed company that pays so-called extra dividends in stock besides its cash dividends will sell at higher prices than a stock which earns the same amount but accumulates the difference as a surplus. If there were no advantage in the declaration of stock dividends, it is reasonable to suppose that these would not be declared. But these advantages, whatever they are, are not income; and as was so well put by Mr. Justice HOLMES in *Towne* v. *Eisner,* "If the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417,450, the sum upon which he was taxed." 245 U. S., at p. 426. (This having been the amount of the so-called stock dividend.)

One of these advantages is that stock dividends afford a convenient way of increasing the cash dividends in a gradual way as the annual earnings may be increased by the earning power of the undivided earnings that are capitalized. A company that each year pays 6 per cent. in cash dividends

and 5 per cent in stock, in reality increases its cash dividends 3/10 of 1 per cent. each year over the year before. It would be difficult to express this regular increase of rate on an unchanged capital stock without having resort to an ever increasing complication of fractions in the dividend rate.

It is surely also an advantage to stockholders to have the fact of the capitalization of earnings officially authenticated by a stock dividend. It does point to the prosperity of their company. Annual stock dividends indicate progressively increasing earning power.

There may be other incidental advantages. The sentiment of having more counters is potent with many persons.

But certainly no one of these advantages nor all of them together constitute income—nor do they make income of that which would not have been income without them.

In any case the advantage of declaring a stock dividend over leaving the same amount in undivided surplus is certainly not equal to the amount of the stock dividend. In fact, these advantages are all speculative or doubtful. In some cases a stock dividend causes a fall in the total market value of the stock holdings. The market's attitude towards stock dividends is always a matter of doubt, and can never be predicted. Sometimes stock dividends are declared where the stock is selling below par, and being badly received by the market, the shares decline still further, although earnings may have fully justified the capitalization of the year's surplus into a stock dividend.

In conservatively managed companies, on the other hand, which pay regular cash dividends and earn a surplus, it cannot be denied that in the long run the payment either regularly or occasion-

ally of stock dividends through a capitalization of earned surplus into shares of stock that are expected themselves to go in the future and pay similar dividends will add considerably to the favor with which such a company is regarded and to the market value of its shares.

In some companies not so conservatively managed such a stock dividend policy would be regarded as unsound finance, and cause a fall in price.

This shows how utterly fallacious it is to regard an increase in market value as income in and of itself, unless it is realized by a sale of stock. It is neither income itself, nor in any slightest degree proof that an unrealized stock dividend is income. If the stocks of well managed companies that pay stock dividends should sell proportionately higher than those of others, in what way does this increase in market value constitute income? Only in one way and that is where the stockholder shall elect to sell. He will then get a higher price, and at that time, the United States Revenue will get a larger income tax because of the fact that the stock-dividend-paying stock will have sold higher proportionately than the stocks of those companies which merely accumulate the same amount in surplus. **The truth is that the United States Revenue will in the long run and over a period of years gain more revenue by a policy of exempting stock dividends than by taxing them.**

But these considerations as raised by Mr. Bond are all incidental and have nothing to do with the main and the intrinsic question which in its two-fold aspect is this:

(1) In sound economics can an undivided surplus of a corporation be regarded as income of the stockholder; and (2) can that same surplus, mere-

ly because capitalized by stock dividends, be deemed income although the stockholder receives nothing intrinsic that he did not have before?

Undoubtedly, these undivided surpluses and these so-called stock dividends do increase the stockholder's capital values. They are gains in a sense, but they are inchoate gains, unrealized gains; they take nothing from the corporation and they only become income when realized through sale. Unlike a dividend in cash or tons of coal, or stocks of other companies, he gets no new thing separated from his company of which he may dispose as he pleases without in any way affecting his interest in his company.

> "While a stock dividend would increase the number of his shares, it proportionately diminishes the value of each of his shares, leaving the aggregate value as it was before."
>
> *Staats* v. *Biograph Co.*, 236 Federal, 454, 457.

Market value then has nothing to do with the case. The whole basis of the claim that a stock dividend is income is that the corporation has made earnings and has capitalized them by this new stock. The basis for the claim is the earnings of the corporation and not the market value of the stock. Now, the earnings of the corporation and the real capital of the corporation are precisely the same whether a stock dividend is declared or whether it is not declared. This fallacy of talking about market values obscures this fundamental fact. The earnings certainly exert an influence on market value. The declaration of a stock dividend may or may not exert an influence on market value but market value has no bearing on the income of the

teenth Amendment cannot now be construed as embracing stock dividends in its use of the word *"Income"* without enlarging it so as to embrace matters not specifically pointed out—without in fact altering the definition of the word laid down by the highest judicial authority and without violating rules of sound economic reasoning as well.

Its use in the sense in which it had been judicially construed should be presumed.

Latimer v. *U. S.*, 223 U. S., 501, 504.

> "It is a well settled rule of construction that language used in a statute which has a settled and well-known meaning sanctioned by judicial decision is presumed to be used in that sense by the legislative body."

And see

Kepner v. *U. S.*, 195 U. S., 100, 124;
The Abottsford, 98 U. S., 440.

SECOND POINT.

Although the *Hubbard* case is plainly distinguishable from the case at bar, it is nevertheless inconsistent both with other and later rulings of this Court and with sound economics. It tends to block the way to a consistent, harmonious and logical system of income taxation and it should be expressly overruled.

The case was decided upwards of fifty years ago, when the income tax had been but little studied either in its economic or in its constitutional aspects.

It turned principally on questions of procedure. The grave constitutional questions involved which were subsequently to demand the most earnest consideration of this Court in the *Pollock* case were scarcely referred to. The *Pollock* case, the Sixteenth Constitutional Amendment and subsequent cases, have since then settled the underlying principles involved.

As the Attorney General substantially rests his case on *Collector* v. *Hubbard,* it will be worth while to analyze this case with some particularity, so as to show how inapplicable it is to present conceptions of taxation—whether economic or constitutional.

Collector v. *Hubbard* (12 Wall., 1) arose under the income tax provisions of Chapter 173, Laws of 1864.

As applied to corporations the scheme of the Act was to provide a 5 per cent. tax on all corporate earnings.

Section 122 provided for a 5 per cent. tax on the amount of interest, dividends or profits of railroad, canal and turnpike companies.

Section 120, a similar tax upon the earnings of banks, trust companies and insurance companies.

Section 117 put all other companies, including manufacturing companies, in a class by themselves and sought to accomplish the same result by the indirect method of taxing the stockholders instead of the corporation. That section provided that the gains and profits of a corporation should be included in estimating the annual gains, profits and income of any person entitled to the same, whether divided or otherwise. In other words, each stockholder in these last named companies, for reasons that do not appear, was required to report as part

of his income his *pro rata* of the earnings, divided or undivided, of any corporation in which he held stock and to pay the 5 per cent. tax thereon, while the corporations themselves of this class were not taxed at all.

Whatever may be thought of making stockholders pay taxes on undivided corporate profits never received and perhaps never to be received by them —the object of the Act at least was to levy a uniform tax on the earnings of all corporations alike for each taxable year. Only the method of assessing or levying the tax varied with the two classes of corporations. This was recognized by the then Attorney General in his argument of that case, wherein he said: "In all cases the entire annual gains and profits of every corporation, divided or undivided, seem to be within the aim and province of the statute as objects of taxation."

This was no case of double taxation. Only one tax was to be levied on any one year's corporate earnings, but that was levied not on the corporation but on its shareholders.

Nor was it a case of taxing the earnings for a year subsequent to the year when earned and at a time when they had really become capital. Least of all was it a case of first exacting an income tax from the corporation in one year and then treating those same earnings though undivided as the income of the stockholder in the next succeeding year.

The corporate earnings of manufacturing companies as such were deemed by the Statute, whether rightly or wrongly, to be the taxable interest of the stockholders but only for the year when earned by the Company.

Whilst it is believed and will be argued later on that any such enactment as Section 117 would now

be unconstitutional—it is important to stress these facts because they establish essential differences between the *Hubbard* case and the contentions of the Government here.

Another important fact is that the constitutionality of making stockholders pay an income tax on income never received by them seems to have received little or no consideration in that case.

Only in the last few short paragraphs of the Court's opinion were the merits considered—that is, the right of Congress to levy such a tax on corporate earnings against the stockholder and after scant consideration it seems to have been thought that the stockholder's interest in the earnings was taxable as a property interest.

(a) The Hubbard case as upholding a tax on property or on the income from property except by apportionment under Article I, §2 of the Constitution has been overruled by the Pollock case.

This the Attorney General virtually admits, but he argues that the tax would have been invalid under the *Pollock* decision, not because the views announced in the *Hubbard* case were unsound, but because the Hubbard tax was a direct tax on property and not apportioned among the states, and he argues in effect that the Sixteenth Amendment, which does not authorize a direct tax at all, but merely relieves from the rule of apportionment taxes on the income of property from whatever source derived, would again today reauthorize a tax like that in the *Hubbard* case.

But the tax involved in the *Hubbard* case actually was a direct tax on property and would be so considered at this day. The Sixteenth Amendment has no application to such a tax. The very

views expressed by the Court and which the Government quotes in its support show that it considered the stockholder's interest in the corporation and its earnings as a property interest. This is what the Court said:

> "* * * undivided profits are the property of the shareholder * * *"
>
> "undivided profits invested in real estate, etc. * * * are investments in which the shareholders are interested."
>
> "Annual gains and profits, whether divided or not, are property and therefore are taxable."

If the shareholder has any interest in these corporate gains and profits before they are divided as dividends, it is a property interest and a tax upon it against the shareholder would be a direct tax now as much as ever. The Sixteenth Amendment does not touch it. For these corporate profits are not income of the shareholder. They are as the Court says, property. As such they may be taxed but the tax being a direct tax would now, since the *Pollock* case, have to be apportioned.

These remarks of the Court that these undivided corporate gains are property of the shareholder may not be easily reconciled with what it elsewhere says to the effect that "it is as competent for Congress to tax annual gains and profits before they are divided among the holders of the stock as afterwards."

If it be meant by that, that Congress has power to tax total corporate gains and profits against the corporation, there can be no doubt of it. But if it be meant thereby that Congress may levy against the stockholder a tax on the undivided gains and profits of the corporation, then with due respect, the statement is not sound law. The stockholder's

interest in these undivided gains is property, as the Court so well said; it is included in his ownership of stock in the corporation and a tax on them would be in effect a tax on his stock, a direct tax and not an income tax.

This confusion of language, if we may be permitted to call it such, is all due to the views generally entertained at the time of the *Hubbard* case which arose in consequence of the *Hylton* case (*Hylton* v. *U. S.*, 3 Dallas, 171) that a tax on carriages or other personal property was an excise tax and not a property tax or a direct tax. Taxes on personal property and on incomes, both having been at that time regarded as excise taxes, there was no occasion for the Court to distinguish between them. Therefore, whether the tax of 1864 were deemed a personal property tax or a tax on profits or on income, it seemed equally to be an excise tax and within the power of Congress. In neither case did an apportionment then seem necessary.

But the *Pollock* case holds that a tax whether on property or on the income from property is a direct tax.

The Sixteenth Amendment merely authorizes a tax on the income from property without regard to apportionment and leaves direct taxes on property, real or personal, where the *Pollock* case left them.

> *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S., 1.

So that the *Pollock* case, notwithstanding the Sixteenth Amendment, remains today as a barrier against the taxation of a stockholder's interest in the corporation or its undivided profits—for these are as to him property and such a tax would be a direct tax.

How can the stockholder's interest in the undivided earnings of his corporation be anything else than property? They are a gain if one please. They constitute an addition to the value of his capital. But for all the control he has over them they are no more of a gain than an appreciation in the value of his real estate. In neither case can he enjoy the gain unless he sell.

In *Southern Pacific Co.* v. *Lowe*, 247 U. S., 330, 335, this Court said, speaking of the accumulations of earnings in that case:

> "* * * we are bound to consider the accumulations that accrue to a corporation prior to January 1, 1913, as being capital and not income. *And we perceive no adequate ground for a distinction in this regard between an accumulation of surplus earnings and the increment* due to an appreciation in the value of the assets of the taxpayer."

And there surely is no distinction as regards the taxpayer at any given date, whether his capital values have increased through mere appreciation in market values as of real estate, or whether his stock has been made more valuable intrinsically by earnings that he is not allowed to receive and enjoy. Neither sort of gain constitutes income to him. This has been abundantly shown in the preceding discussion of economic doctrine. But the man in the street knows this for himself without argument. He knows that where a corporation fails to pay him dividends out of its earnings he has no income. An appreciation of capital he may have. This may even be ultimately more valuable to him than the cash dividend. But income it is not. It cannot pay butcher's or grocer's bills or taxes. And income which cannot be made to do these things is

not intrinsically income, and it seems preposterous to suppose that the Sixteenth Amendment could refer to income in any such sense. These unrealized gains are property, are capital, and nothing else.

It may be proper to tax these accretions—appreciation in value of real estate or securities, undivided surplus of corporation. But if so, they should be taxed for what they are—property interests—and the taxes would have to be apportioned. Before they can properly be taxable as income either in the economic or in the popular sense or as we believe in the constitutional sense, they must be made income by a sale of the property so that the gains may have been realized.

The title both legal and equitable in corporate property and in corporate earnings is in the corporation. This the Court admitted in the *Hubbard* case. If the title is in the corporation, then it certainly is not in the stockholder, and it is difficult to see how he can have any taxable interest either in the corporate property or its earnings. The Court there avoided this difficulty by remarking that the stockholder is an owner of shares and that one of the incidents of shares is "the right to receive all future dividends." But the right to receive future dividends, which may never be declared, is certainly not the same thing as the receipt of real dividends actually declared—and such a right certainly does not constitute income. It is an inherent right of property in the shares and it is a property attribute but it is a contingent right at best.

The notion that such an abstraction as a contingent right to receive future dividends if and when other wills than ours choose to declare them constitutes a present taxable income for us, shows how thoroughly the Court was governed in the *Hubbard*

case by the authority of the *Hylton* case, that a tax on carriages and personal property generally was an excise tax and similar in that regard to the income tax—a view definitely overruled by the *Pollock* case, and which to that extent must be deemed to have been confirmed by the Sixteenth Amendment.

But *Gibbons* v. *Mahon*, 136 U. S., 549, is decisive of this question, that a stockholder's interest in corporate earnings is property, is capital.

> **"Reserved and accumulated earnings, so long as they are held and invested by the corporation, being part of its corporate property, it follows that the interest therein represented by each share is capital and not income of that share, etc., etc." (p. 558).**

So that in whatever way one looks at the *Hubbard* case, and whatever way may have been the judicial view in 1864, the subject matter there taxed was not income but property and being property the case and the grounds upon which it rested have been overruled by *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S., 429.

(b) THE HUBBARD CASE, INSOFAR AS IT ASSUMES AN EQUIVALENCY BETWEEN THE PROPERTY AND THE INCOME OF THE CORPORATION AND THE SHARES OF STOCK IN THE NAMES OF THE STOCKHOLDERS FOR TAXATION PURPOSES, HAS BEEN IMPLICITLY OVERRULED BY A LONG SERIES OF AUTHORITIES IN THIS COURT.

The novel principles imagined in Chapter 173, Laws of 1864, for imposing the income tax of a corporation upon its stockholders and the views expressed thereon in Collector v. Hubbard as interpreted by the Attorney General here, would completely obliterate the well-established legal entity of the corporation as distinct from its stockholders and make of it for taxation purposes a partnership.

They do more, because in a partnership, partners required to pay a debt of the partnership would have recourse to the corporate fund to recoup themselves. But stockholders paying a tax under the Act of 1864 on the undivided earnings of their corporations would have no such right to compel repayment by the corporation.

The corporate entity cannot be disregarded as is urged by the Government in this case, or as the language used by Mr. Justice Clifford in the Hubbard case would seem to warrant.

> "The corporation is a person distinct from the stockholder. It is true, it is what is denominated an artificial person, and may be said to be ideal and intangible. But that it is a person in law is the first principle learned by the student in opening any book on corporations. Its stockholders are distinct and different persons. They are usually not liable for its debts, and have no right to the *enjoyment or possession* of its property during the period of its duration or until it be dissolved by some procedure known to the law." (Italics ours.)
>
> *Cook* v. *Burlington*, 59 Iowa, 251.

In an early decision of this Court, in which the opinion was written by no less a personage than Chief Justice MARSHALL, the Court permitted itself to ignore the separate legal entity of a corporation, and to treat it as a mere aggregation of its members. But subsequent consideration satisfied the Court of its error, and even the illustrious Chief Justice acknowledged the mistake made in departing from the settled principles of corporation law. The history is interesting and instructive. The case was that of *Bank of United States* v. *Deveaux*, 5 Cranch, 84. The question there was, whether or not a corporation might sue in the Federal Courts

under the Judiciary Act, which extended the judicial power of the United States to controversies between citizens of different States. Was a corporation a citizen of the State of its incorporation within the meaning of this act, irrespective of the citizenship of its members? The Court decided it was not. Chief Justice MARSHALL, writing the opinion of the Court (following a previous ruling in *Strawbridge* v. *Curtis*, 3 Cranch, 267), held that

> "That invisible, intangible, and artificial being, that mere legal entity, a corporation aggregate, is certainly not a citizen; and, consequently, may not sue or be sued in the courts of the United States, unless the rights of the members, in this respect, can be exercised in their corporate name. If the corporation be considered as a mere faculty, not as a company of individuals, who in transacting their joint concerns, may use a legal name, they must be excluded from the courts of the union."

Therefore, it was held that the Court might look to the character of the individuals who composed the corporation, and if all of them were citizens of a state other than that of the opposite party to the suit, maintain the jurisdiction of the Federal Court, but not otherwise. This decision is about the only recorded example of a narrow construction by Chief Justice MARSHALL of the powers granted by the Constitution to the federal government.

In *Louisville R. R. Co.* v. *Letson* (2 How., 497), the question again was presented to the Court. Referring to the previous decisions of *Bank of United States* v. *Deveaux* (5 Cr., 84) and *Strawbridge* v. *Curtis* (3 Cr., 267), Mr. Justice WAYNE delivering the unanimous opinion of the Court said:

> "We do not deny that the language of those decisions do not justify in some degree the in-

ferences which have been made from them, or that the effect of them has been to limit the jurisdiction of the circuit courts in practice to the cases contended for by the counsel for the plaintiff-in-error. The case of *Strawbridge* and *Curtis* was decided without argument. That of the *Bank* and *Deveaux* after argument of great ability. But never since that case has the question been presented to this Court, with the really distinguished ability of the arguments of the counsel in this, in no way surpassed by those in the former. And now we are called upon in the most imposing way to give our best judgments to the subject, yielding to decided cases everything that can be claimed for them on the score of authority, except the surrender of conscience. After mature deliberation, we feel free to say, that the cases of *Strawbridge* and *Curtis,* and that of the *Bank* and *Deveaux,* were carried too far, and that consequences and inferences have been argumentatively drawn from the reasoning employed in the latter which ought not to be followed. Indeed, it is difficult not to feel that the case of *The Bank of the United States* and *The Planters' Bank of Georgia,* 9 W., 904, is founded upon principles irreconcilable with some of those on which the cases already adverted to were founded. The case of *The Commercial Bank of Vicksburg and Slocomb,* 14 P., 60, was most reluctantly decided upon the mere authority of those cases. We do not think either of them maintainable upon the true principles of interpretation of the constitution and laws of the United States. A corporation, created by a State, to perform its functions under the authority of that State, and only suable there, though it may have members out of the State, seems to us to be a person, though an artificial one, inhabiting and belonging to that State, and therefore entitled, for the purpose of suing and being sued, to be deemed a citizen of that State. We remark,

too, that the cases of *Strawbridge* and *Curtis*, and the *Bank* and *Deveaux*, have never been satisfactory to the bar, and that they were not, especially the last, entirely satisfactory to the court that made them. They have been followed always most reluctantly and with dissatisfaction. By no one was the correctness of them more questioned than by the late Chief Justice who gave them. It is within the knowledge of several of us, that he repeatedly expressed regret that those decisions had been made, adding, whenever the subject was mentioned, that if the point of jurisdiction was an original one, the conclusion would be different. We think we may safely assert, that a majority of the members of this court have at all times partaken of the same regret, and that, whenever a case has occurred on the circuit, involving the application of the case of the *Bank* and *Deveaux*, it was yielded to, because the decision had been made, and not because it was thought to be right. We have already said that the case of *The Bank of Vicksburgh* and *Slocomb*, 14 Pet., 60, was most reluctantly given, upon mere authority. We are now called upon, upon the authority of those cases alone, to go further in this case than has yet been done. It has led to a review of the principles of all the cases. We cannot follow further, and upon our maturest deliberation we do not think that the cases relied upon for a doctrine contrary to that which this court will here announce, are sustained by a sound and comprehensive course of professional reasoning. Fortunately, a departure from them involves no change in a rule of property."

This decision was followed in *Marshall* v. *B. & O. R. R. Co.*, 16 How., 314, and *Covington D. Co.* v. *Shepherd*, 20 How., 227, and the rule there adopted that a corporation is a legal entity—a person—created by the state of its incorporation, entirely

distinct from the individuals who compose its membership, was definitely and finally declared to be the law by Chief Justice TANEY in *O. & M. R. R. Co.* v. *Wheeler,* 1 Black, 286.

In *Humphreys* v. *McKissick,* 140 U. S., 304, 312, Mr. Justice FIELD said:

> "The property of a corporation is not subject to the control of individual members, whether acting separately or jointly. They can neither encumber nor transfer that property, nor authorize others to do so. The corporation—the artificial being created—holds the property, and alone can mortgage or transfer it, and the corporation acts only through its officers, subject to the conditions prescribed by law."

In *Donnell* v. *Herring-Hall-Marvin Safe Co.,* 208 U. S., 267, 273, Mr. Justice HOLMES said:

> "Philosophy may have gained by the attempts in recent years to look through the fiction to the fact and to generalize corporations, partnerships and other groups into a single conception. But to generalize is to omit, and in this instance to omit one characteristic of the complete corporation, as called into being under modern statutes, that is most important in business and law. A leading purpose of such statutes and of those who act under them is to interpose a non-conductor, through which in matters of contract it is impossible to see the men behind."

In *Southern Pacific Co.* v. *Lowe,* 247 U. S., 330 (1918), the corporate fiction was disregarded but the case is valuable for PITNEY, J.'s, caution (page 338) that:

> "The case turns upon its very peculiar facts and is distinguishable from others in which the question of the identity of a controlling stockholder with his corporation has been raised."

In this case, the Southern Pacific Co. owned all the stock in the Central Pacific Railroad; the latter railroad had earned certain surplus profits and these the Southern Pacific Co., as sole stockholder, caused to be converted into a cash dividend, and paid to itself. The surplus profits accrued before March, 1913; the dividend was declared and paid after March, 1913. The transaction was held not taxable.

In *Pullman Car Co.* v. *Missouri Pacific Railway Co.,* 115 U. S., 587 (1885), it was held that an agreement by the respondent railroad to haul Pullman cars over roads controlled by lease or ownership did not import an obligation to haul cars over roads owned by companies in which the respondent held practically all the stock. In *Peterson* v. *Chicago, Rock Island & Pacific Railroad,* 205 U. S., 364, 391 (1907), it was held that a railroad was not shown to be doing business in a certain State if it was merely shown to have been the owner of practically the entire capital stock of another railroad which operated in that particular State. See also *Stone* v. *Cleveland C. C. & St. L. Railroad,* 202 N. Y., 452 (1911).

The same principle was involved in *Continental Tyre Co.* v. *Daimler* (1915), 1 K. B., 893 (reversed by the House of Lords on a question of termination of agency by war (1916) 2 A. C. 307). The issue there was the permissibility of payments in wartime to a corporation chartered under the English Companies Act, the majority of whose stockholders were subjects of Germany. The court rejected the plea of the debtor that the substance and not the technicalities of the matter should be regarded, saying:

> "It cannot be technically an English company and substantially a German company ex-

cept by the use of inaccurate and misleading language. Once it is validly constituted as an English company it is an artificial creation of the Legislature and it retains its existence for all intents and purposes. It is a living thing with a separate existence which cannot be swept aside as a technicality. It is not a mere name or mask or cloak or device to conceal the identity of persons and it is not suggested that the company was formed for any dishonest or fraudulent purpose. It is a legal body clothed with the form prescribed by the Legislature."

A like decision was rendered by the New York Supreme Court in a similar case. See *Schulz* v. *Raimes,* 100 Misc. (N. Y.), 697 (1917).

This principle especially should be adhered to on a question of taxation.

Taxes are, fundamentally, the price paid by property owners for the assurance to them by the State that they will be protected in the enjoyment of their property. *Union Refrigerator Transit Co.* v. *Kentucky,* 199 U. S., 194, 204 (1905). They should therefore not be assessed upon property which they have no right to enjoy.

The exceptional cases where the corporate entity has been disregarded but serve to prove the rule.

These cases generally are those where not to disregard the fiction, would permit the corporation or its stockholders to evade contractual obligations or commit a fraud or a crime with impunity, or, as in *Southern Pacific Co.* v. *Lowe, supra,* would permit the imposition of unjust burdens upon the corporation.

In *United States* v. *American Refrigerator Transit Co.,* 142 Fed., 247 (1905), the United States sought to restrain the paying of rebates to a shipper in violation of the Elkins Act. The defense was that

the defendant was not a shipper but a freight soliciting agent. All the stock in the defendant was owned by the Pabst Brewing Co., and members of the Pabst family, and the Brewing Company made all its shipments through the defendant's agency. It was held that the corporate fiction would be disregarded and an injunction issue.

(*United States* v. *Lehigh Valley Railroad,* 200 U. S., 257 (1911); *United States* v. *Delaware, L. W. Railroad,* 238 U. S., 516, 529 (1915); *Brundred* v. *Rice,* 49 Oh. St., 540, involve a similar principle.)

In *Linn Timber Co.* v. *United States,* 236 U. S., 574 (1915), it was held that one who had notice of a defect in his title could not create a corporation and, becoming its chief stockholder, sell his land to the corporation as to a *bona fide* purchaser, with a view toward cutting off the claims which had made his title defective.

In *People* v. *North River Sugar Refining Co.,* 121 N. Y., 582 (1890), several corporations engaged in the business of refining sugar, including the defendant corporation, made through their directors an agreement whereby all the stock of all the corporations was transferred to certain trustees. The defendant then ceased to refine sugar. Upon the bringing of a writ of *quo warranto* to wind up the corporation, the contention was made that the corporation had committed no offense, and that only the stockholders and directors were guilty. The court refused to recognize the corporate fiction and, holding that there had been corporate action, refused to allow the writ to be defeated by "the assumed innocence of a convenient fiction" (p. 622).

In *First National Bank* v. *Trebein,* 59 Oh. St., 316, 52 N. E., 834 (1898), the debtor Trebein formed a corporation with his wife, daughter, son-in-law

and brother-in-law, and conveyed all his property to it. The court ordered the conveyance set aside, but denied that the property could have been sold on execution by Trebein's own creditors prior to reconveyance. The language of the court, however, on the circumstances under which the fiction may be disregarded goes beyond the rule sustained by authority.

> "But modern cases, sustained by the best text writers, confine the fiction to the purposes for which it was adopted—convenience in the transaction of business and in suing and being sued in its corporate name, and the continuance of its rights and liabilities, unaffected by changes in its corporate members; and have repudiated it in all cases where it has been insisted on as a protection to fraud or any other illegal transaction."

A better statement of the law is that of HAIGHT, D. J., in *Peckett* v. *Wood*, 234 Fed., 833, 838 (1916), quoted *infra*, p. 49.

There seems to be perfect unanimity among the authorities in cases where a person, having contracted not to engage in a certain business, proceeds to form a corporation with himself as chief stockholder and to carry on the prohibited business under the corporate name. It is proper in such cases to enforce the contract by injunction directed against the corporation: *Moore & Handley Co.* v. *Towers Hardware Co.*, 87 Ala., 206 (1880); *Beal* v. *Chase*, 31 Mich., 490; *Hall's Safe Co.* v. *Herring-Hall-Marvin Safe Co.*, 146 Fed., 37 (1906). But a strong case for preserving intact the corporate fiction though it be employed to evade a detrimental contract is *People's Pleasure Co.* v. *Rohleder*, 109 Va., 439, where a covenant not to convey to persons

of African descent was held not violated by conveyance to a corporation composed exclusively of colored persons.

The case of *In re Rieger,* 157 Fed., 609, along with *In re Muncie Pulp Co.,* 139 Fed., 546 and *Hunter* v. *Baker Motor Vehicles Co.,* 225 Fed., 1006, aff'd. 238 Fed., 894, are instances of the "mere adjunct" cases where the corporate fiction is regarded with impatience. In those cases it was disregarded, not because to do so is the only way to prevent fraud, but simply to avoid circuity of action and expenditures of time—"in a case where a corporation is so organized and controlled and its affairs are so conducted as to make it merely an instrumentality or adjunct of another corporation." Per NOYES, C. J., *In re Watertown Paper Co.,* 169 Fed., 252, 256 (1909). These "mere adjunct" cases are unsound in that they turn on what is at best a question of degree; and they furnish no unequivocal criterion of responsibility. They have not been approved by this Court.

Judge NOYES, in his opinion, reaffirmed the general rule in this language:

> "Now, it is an elementary and fundamental principle of corporation law that a corporation is an entity separate and distinct from its stockholders and from other corporations with which it may be connected. The fact that the stockholders of two separately chartered corporations are identical, that one owns shares in another, and that they have mutual dealings, will not, as a general rule, merge them into one corporation, or prevent the enforcement against the insolvent estate of the one of an otherwise valid claim of the other * * *. Unless, therefore, it can be shown that some exception to the general rule of separate existence and liability applies in this case, it must follow that the

claim of the Pulp Company should have been allowed."

HAIGHT, D. J., in *Peckett* v. *Wood,* 234 Fed., 883, 838 (1916), in an opinion upon which the C. C. A. (3rd Circ.) affirmed the judgment, insists very strongly upon the recognition of the corporate entity except for the prevention of fraud, or some like consideration.

> "Although, as was said in the *Watertown Paper Company* case, *supra,* in some cases, when necessary for the furtherance of justice in one way or another, corporate entity may be disregarded where the corporation is so organized and controlled and its affairs are so conducted as to make it merely an instrumentality or adjunct of another concern, yet this is an exception to the general rule and fundamental principle that a corporation is an entity, separate and distinct from its stockholders, and from other concerns with which it may be connected * * *. Except in cases where it is necessary to circumvent fraud, or in cases which proceed on the theory of estoppel, or those where it is sought to take possession of property ostensibly belonging to a corporation entirely controlled and owned by the principal debtor, for the purpose of protecting the creditors of the latter, as well as the former, it will be found that the instances are rare indeed where the general and settled rule of separate corporate identity is disregarded."

The provisions of Section 3 of the Income Tax Law of 1916, fall within the exceptions to the general rule. The section provides that:

> "For the purpose of the additional tax, the taxable income of any individual shall include the share to which he would be entitled of the gains and profits, if divided or distributed,

> whether divided or distributed or not, of all corporations, joint stock companies or associations, or insurance companies, however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such company * * * is a mere holding company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a fraudulent purpose to escape such tax * * *."

That a fraud upon the law may not be accomplished by resorting to an otherwise legal form of organization is well settled. The anti-trust cases are illustrations of this principle—

> *Northern Securities Co.* v. *U. S.*, 193 U. S., 197;
> *Standard Oil Co.* v. *U. S.*, 221 U. S., 1;
> *U. S.* v. *American Tobacco Co.*, 221 U. S., 106.

The separateness of the corporation and its shareholders has never been more emphatically expressed than in recent opinions of this Court. In *Gibbons* v. *Mahon*, 136 U. S., 549, it was said:

> **"The distinction between the title of a corporation and the interest of its members or stockholders in the property of the corporation is familiar and well settled.** The ownership of that property is in the corporation, and not in the holders of shares of its stock. The interest of each stockholder consists in the right to a proportionate part of the profits whenever dividends are declared by the corporation during its existence under its charter, and to a

like proportion of the property remaining, upon the termination or dissolution of the corporation, after payment of its debts.

"Money earned by a corporation remains the property of the corporation and does not become the property of the stockholders unless and until it is distributed among them by the corporation. The corporation may treat it and deal with it either as profits of its business, or as an addition to its capital."

In *Lynch* v. *Hornby*, 247 U. S., 339, this Court said:

"The stockholder is in the ordinary case a different entity from the corporation * * *"

In *Peabody* v. *Eisner*, 247 U. S., 347, it was said:

"In this case the plaintiff-in-error stands in the position of the ordinary stockholder, whose interests in the accumulated earnings and surplus of the company are not the same before as after the declaration of a dividend; his right being merely to have the assets devoted to the proper business of the corporation and to receive from the current earnings or accumulated surplus such dividends as the directors, in their discretion, may declare; and without right or power on his part to control that discretion."

See also a long line of cases on the taxation of bank stock, etc., cited in the main brief of defendant-in-error, wherein it is held that the shares of stockholders may be taxed although the capital of the bank be exempt, the reason being that the capital with its surplus owned by the corporation and the shares owned by the stockholders are different and distinct. Both the nature of the things owned and the ownerships are different.

These principles of law are elementary.

In the case of *Owensboro National Bank* v. *Owensboro*, 173 U. S., 664, Mr. Justice WHITE, referring to these authorities, said:

> "If the postulate upon which they necessarily rest be overthrown by saying that there is an equivalency between the taxation of the property of the Bank and the shares of stock in the names of the stockholders, it would follow that the principles upheld by the cases would disappear with the destruction of the reasons upon which they were placed."

It is because there is no such equivalency that shares may still be taxed where corporate property is exempt by law. Since this equivalency of ownership and this equivalency for taxation purposes is denied as between the shares on the one hand and the corporate property on the other, it follows that the corporate property and the earnings of the corporation cannot be imputed to the holder of the shares for taxation purposes, for this would be to admit the equivalency of the two titles for taxation purposes, which this long series of cases has denied; and *Gibbons* v. *Mahon*, *supra*, overrules the *Hubbard* case, where it says that "money earned by a corporation that is, its income, remains the property of the corporation and does not become the property of the stockholders unless and until it is distributed among them by the corporation."

These cases and the citations that follow are utterly inconsistent with the doctrine of regarding corporate earnings as the income of shareholders. They implicitly overrule the *Hubbard* case and that case should be explicitly overruled.

The net result of the decisions is accurately and

tersely summed up in Vol. 10, Cyclopedia of Law and Procedure, as follows:

"Capital and shares are species of property distinct from one another. The capital or capital stock belongs to the corporation considered as a legal person or entity; the shares are the property of the individual shareholders."

"Shares of stock are personal property."

"Shareholders are not tenants in common or co-owners of the property of the corporation in any sense; but the title thereto rests in the legal entity called the corporation."

"It follows that a shareholder's interest in the property of the corporation cannot be seized and sold under judicial process as can the interest of a partner or tenant in common, although his shares, considered as distinct property, can be."

"The relation of trustee and 'C. Q. T.' of debtor and creditor, or of partners, does not exist between the shareholders of an incorporated company and the corporation itself." They may deal with one another as strangers.

"As already stated, a joint-stock corporation is in general a trustee for its shareholders only so far as may be necessary for the protection of their several rights of property in their several shares."

"Non-liability at Common Law. 1. General Rule. As already seen, a corporation and its shareholders are distinct persons in law. The general rule of law, therefore, is that the shareholders of the joint-stock corporation are not liable for its debts or for its torts, except to make good the amount due to the corporation for their shares, unless made so by constitutional or statutory enactment, or unless they have assumed a larger liability by contract or by conduct."

See pp. 364, 366, 373, 374, 376, 649.)

Not being liable for the corporation's debts, why should they be liable for its taxes?

Elementary as these principles are, it is worth while to recall them in order to show how they contradict the theory that for taxation purposes the undivided earnings of a corporation are the earnings of its stockholders.

There is no element of wrong-doing here—no attempt to evade the payment of a just tax. The contention is that any corporation as a separate legal entity having earned profits should pay the income tax on them. There is no difficulty in compelling it to do so. It is admitted that to the extent that these profits may be actually distributed in dividends the stockholders should pay another tax as on income received by them. It is contended that to make stockholders pay an income tax on the undistributed earnings of a corporation not received by them (as was done in Section 117, Chapter 73, Laws 1864) would not only be a monstrous injustice in itself, but would withdraw that protection against personal liability which the stockholder depends upon in embarking his money and which is one of the principal reasons for the legal fiction of separate corporate entity and separate ownership of property.

So far from this being a case for an exception to the rule of corporate entity, it is a case involving one of the fundamental reasons for its assertion.

Now this rule and the principle of stockholders' exemption from liability are laid down as rules of law by the various states under whose laws most corporations are incorporated. Can it be possible that the Congress has been clothed with the constitutional power to set aside these rules of property for the purpose of levying an income tax not against the corporation which has earned and still holds

the income but against stockholders who do not hold it and may never receive it?

If so, then it would not be difficult to imagine an income tax of 65 per cent. or so levied against some large stockholder upon so-called income of his still held by the corporation—the payment of which could work his ruin.

And a new tax act in such case might levy a similar confiscatory tax on all stockholders alike—big and little. This would be worse than confiscation—for confiscation takes only what one has. This sort of an 1864 tax on undivided corporate earnings would compel stockholders to get money elsewhere by loan or otherwise to pay on income they had never received and perhaps never would receive.

These are but a few of the inequalities and injustices and difficulties that will be met if that principle of Chapter 173, Laws of 1864, is sustained, which permits the taxing power to tax income not where it is but where it is not—to tax the stockholder on earnings of the corporation not received by him.

If Congress may tax these undivided earnings against the stockholder when he has not received them, may it tax them again if and when he receives them as a cash dividend?

And if he pay a tax on them whilst controlled by the company, must he pay again on the profit that his stock may realize when he comes to sell it—a profit made possible by these very accumulated earnings?

Nothing can save us from these inconsistencies but an adherence to the well-established rule and beneficent fiction of the law—that the corporation is a distinct person and entity.

(c) The suggestion that this Court has in other cases cited Collector v. Hubbard or its principle with approval except upon altogether minor points is erroneous.

The case of *Bailey* v. *Railroad Company,* 22 Wallace, 604, relied upon by the Government as maintaining the same principles and justifying the taxation of stock dividends has no application here. The case involved a revenue act which taxed not the stockholders but the Railroad Corporation upon all dividends in scrip or money, declared by the Railroad Company as part of the earnings, profit, income or gains of the Company, etc. The earnings of the Railroad Company were manifestly a proper subject for income tax or excise tax. The payment of these earnings in cash dividends among the stockholders or the issuance of scrip was regarded as a fit subject of taxation against the corporation and probably would be so today; but no such question is involved here. No stock dividend was directly involved. It was remarked by this Court subsequently in *Gibbons* v. *Mahon,* that the opinion in the *Bailey* case of Mr. Justice CLIFFORD, the same judge who wrote the opinion in the *Hubbard* case, contained "some general expressions which taken by themselves might seem to ignore the settled distinction between the property of a corporation and the interests of the shareholders." But these remarks of the learned Justice were *obiter* and did not affect the decision of the case, and the learned Justice in making them was undoubtedly governed by the idea prevailing at that time that as a result of the *Hylton* case personal property and its use as well as earnings were a fit subject for an excise tax. If, however, there be anything in the *Bailey* case which seems to lend support to the *Hubbard*

case, whether directly or *obiter,* it must be deemed to have been overruled with the latter case.

In *Lynch* v. *Turrish,* 247 U. S., 221, the question was whether when a corporation was liquidated *in toto* in 1914 the profits that had accumulated on the shares prior to March 1, 1913, could be deemed income or capital. The Court decided that the income had become capital. In reference to *Collector* v. *Hubbard,* it did say that it had been there held that the stockholder could have an interest taxable under the act considered (that of 1864) but it hastened to point out that his interest was *"not identical with the corporation"* and it gave no consideration whatsoever to the question whether such stockholder's interest could be considered income or capital and whether if taxed at this time it could be taxed as income without apportionment or as property with apportionment.

But the most significant fact in answer to the Government's reliance on *Collector* v. *Hubbard* is that in *Southern Pacific Co.* v. *Lowe,* 247 U. S., 330, this Court having an opportunity to rest its decision on *Collector* v. *Hubbard* declined to do so.

In that case the Southern Pacific Company owned all the capital stock of the Central Pacific R. R. Co., and was in possession of all its property and earnings under lease and it treated the whole as its own. Accumulations of earnings had been taken over by it and constituted technically a debt from the lessee. But as the lessee owned all the lessor's stock a formal dividend at any time would have *pro tanto* wiped out the debt. This dividend was not declared formally until 1914, and the Treasury Department claimed that this was taxable as for that year, although the earnings had been received before March 1, 1913, and although this declaration

of dividend was nothing more than a formal ratification by the directors of what was already a *"fait accompli."*

This Court held this dividend not taxable for certain reasons set forth in its opinion. But it expressly disclaimed the idea that it was influenced by *Collector* v. *Hubbard,* and the Court said:

> "We do not rest this (decision) upon the view that for the purposes of the Act of 1913 stockholders in the ordinary case have the same interest in the accumulated earnings of the company before as after the declaration of dividends. The Act is quite different in this respect from the Income Tax of June 30, 1864, under which this Court held in *Collector* v. *Hubbard* * * * that an individual was taxable upon his proportion of the earnings of the corporation, although not declared in dividends."

The Court went on to distinguish that case from the one then at bar.

Only a term or two before *Lynch* v. *Turrish,* this Court had occasion to decide *Towne* v. *Eisner* and it there based itself on *Gibbons* v. *Mahon,* 136 U. S., 549, in which case the distinction between corporate ownership and the interest of shareholders was clearly set forth in this language:

> "The ownership of the property is in the corporation and not in the holders of shares of its stock * * *. Money earned by a corporation remains the property of the corporation and does not become the property of the stockholder unless and until it is distributed among them by the corporation."

In confirmation of this same idea, this Court in *Towne* v. *Eisner* in effect said that if the sum in

question had been carried from surplus to capital account without any stock issue "we do not suppose that anyone would contend that the plaintiff received an accession to his income"; but this is exactly what the Government pretends took place in *Collector* v. *Hubbard*.

As we read these words of the Court, they are in direct contradiction of the Government's view of the *Hubbard* case, and of the *dictum* of the Court in the case itself.

As we read them, those words quoted from Towne v. Eisner say plainly that undivided earnings passed by a corporation from surplus to capital account would not constitute income of a stockholder, and so we come back to the query—are they made income by the mere fact that their capitalization is represented by new stock certificates issued in the same proportions as the old?

THIRD POINT.

The stock dividend is in reality not a dividend at all. It is a mere certified expression of an undivided surplus and its capitalization.

Whatever gain there may be in either case to the stockholder is a capital gain.

Capital gains (being mere increases in valuation) are not income until realized.

The gains that come with stock dividends when stock is sold are realized capital gains—the same in nature and similarly taxable as those gains that are made with any stock that is sold at an advance. Inasmuch as undivided corporate earnings cannot be taxed as income against the stockholder the stock certificates issued with respect of such earnings may not be so taxed, until the gain be realized by the stockholder through sale of his stock.

The proponents for the treatment of stock dividends as income do not altogether agree upon the grounds of the faith that is in them.

Thus some courts consider that a stock dividend is like a cash dividend with an option to subscribe to an equal amount of new stock—and so by calling it a cash dividend, though no cash passes, they impute to it the quality of cash income (see *Tax Comm'r* v. *Putnam*, 227 Mass., 522, also the *Swan* case, *infra*).

The Attorney General on the other hand, basing his case on what we consider the erroneous *dictum*

of the *Hubbard* case, is obliged to concede that a stock dividend is like an undivided corporate surplus.

But he argues that because undivided corporate profits were thought fifty years ago to be taxable as against the stockholders, so may those profits now be similarly taxed when represented by new stock certificates. Or, as he puts it, the right to tax undivided profits "could not be destroyed by the issuance of stock certificates to represent these undivided profits."

Thus far we agree with him in his analysis of what the stock dividend really is. But his conclusions as to its taxability fail to follow because the *Hubbard* case (as shown *supra*) has been overruled in fact by the *Pollock* case and in principle by other rulings of this court and is contrary to sound law and sound economics generally.

And, because further, whilst it is perfectly true that at any instant of time a stock dividend is similar to the undivided profits which have occasioned it—it is also true that the attempt in Chapter 173, Laws 1864, was to tax corporate earnings for the actual year when earned, whilst the stock dividends here being considered present a case of taxing the undivided corporate earnings which they represent for the year after they had been earned and when they had really become capital—and when the corporation itself had already paid its income tax on these very earnings.

With the failure of the *Hubbard* case to support him, the Attorney General's argument falls to the ground.

But it remains true as he admits that a stock dividend is like an undivided corporate surplus—and since the latter is not taxable as income of the

stockholder, it follows that the former cannot be.

The other and opposing view, that a stock dividend is like a cash dividend with a right to subscribe to new stock is easily disposed of on analysis.

This is the view maintained in *Swan Brewery Co., Ltd.*, v. *The King*, Law Reports (1914) A. C., 231, and in *Tax Commissioner* v. *Putnam*, 227 Mass., 522, cases both decided before the recent tax decisions of this Court and in conflict with them, and cases both occurring in jurisdictions where there was no constitutional limitation of the taxing power.

Corporations sometimes do declare a cash dividend and give also a right to subscribe to new stock.

When they do this, stockholders have three courses open to them after receipt of their cash.

1. They may keep the cash and refuse to subscribe, and this they will do in case the conditions should become unfavorable or the stock decline to par or below as frequently happens in these cases, or

2. They may keep their cash dividend and sell their rights to subscribe in case these command a premium. In which case they make a realized gain in addition to their cash dividend which is taxable as income, or

3. They may subscribe and hold the new stock and thus keep up their former percentage of stock control and of right to future dividends.

In the case of a stock dividend pure and simple, this last is the only course open to the stockholder. He is given no choice whatsoever—no power of disposal whatsoever over any new thing.

The theory we are considering ignores the difference between giving a stockholder cash with three

options—and giving him no cash and no option. Notwithstanding the *Swan* case and the *Putnam* case, the stock dividend gives the stockholder no cash and no option

Of course, in either case the stockholder may sell stock. And when he does so his profits will constitute income.

It is a figment of the imagination to assert that two things so radically different are in reality the same.

Not only is the view thus entertained in the *Swan* case and the *Putnam* case directly contradicted by *Gibbons* v. *Mahon* and *Towne* v. *Eisner,* it is also contradicted by the unifying principle which led to superficially contradictory results in *Lynch* v. *Hornby* (*supra*) and *Towne* v. *Eisner* (*supra*).

In both these cases dividends had been declared after March 1, 1913, out of corporate earnings that had been accumulated before that date, but in *Lynch* v. *Hornby* the dividend was made in cash whilst in *Towne* v. *Eisner* the so-called dividend was made in stock. This Court held that the cash dividend, though accumulated from earnings made before the Sixteenth Amendment, was income to the stockholder for the year 1914 when received by him; whilst it also held in *Towne* v. *Eisner* that the stock dividend distributed in 1914 out of earnings accumulated before the Sixteenth Amendment was not income but capital. The unifying principle which produced these opposite results was the distinction between capital and income—a cash dividend, unless in liquidation, being always income and a stock dividend being always capital. This negatives in the most direct and positive way the false analysis employed in the *Swan* case and the *Putnam* case,

which would liken the stock dividend in any regard whatsoever to a cash dividend. A stock dividend, therefore, is plainly not like a cash dividend with a right of subscription to new stock.

The government's other analysis is the correct one, viz.: that undivided profits and stock dividends are intrinsically the same thing as regards the stockholder and their effect on his income.

His gain in both cases is an inchoate, contingent, unrealized, unseparated gain giving him nothing new whatsoever to control or dispose of.

His gain is a capital gain. As was said in *Gibbons* v. *Mahon* (*supra*):—"* * * accumulated surplus * * * being part of its corporate property, it follows that the interest therein represented by each share is capital and not income of that share."

His interest in the company and in all its property is absolutely unchanged in either case.

> "A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the shareholders. Its property is not diminished and their interests are not increased. After such a dividend, as before, the corporation has the title in all the corporate property; the aggregate interests therein of all the shareholders are represented by the whole number of shares; and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones."
>
> *Gibbons* v. *Mahon*, 136 U. S., 549.

> "If the sum had been carried from surplus to capital account without a corresponding issue of stock certificates, which there was noth-

ing in the nature of things to prevent, we do not suppose that anyone would contend that the plaintiff had received an accession to his income. Presumably his certificate would have the same value as before. Again, if a certificate for $1,000 par were split up into ten certificates each for $100, we presume that no one would call the new certificates income. What has happened is that the plaintiff's old certificates have been split up in effect, and have diminished in value to the extent of the value of the new."

Towne v. *Eisner,* 245 U. S., 418, 426.

And Prof. Seligman puts it the same way when he says: "The stock dividend is like an increased surplus: it is not like a cash dividend. In fact a stock dividend is not a dividend at all in the sense in which a cash dividend is a dividend. What is most important above all is he (the stockholder) is no richer than he would have been if there had been no dividend at all, but a simple distribution to surplus." (cf. Prof. Seligman's article *supra* at pp. 534 and 535 of the Review or at page 81 of the reprint herewith.)

For the foregoing reasons, it is respectfully submitted that the judgment of the District Court was correct and should be affirmed.

GEORGE W. WICKERSHAM,
CHARLES ROBINSON SMITH,
Amici Curiae.

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Supreme Court, U. S.
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No. 914, 318

IN THE

Supreme Court of the United States,

OCTOBER TERM, A. D. 1918.

MARK EISNER, COLLECTOR, ETC.,
Plaintiff-in-Error,

against

MYRTLE H. MACOMBER,
Defendant-in-Error.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF AND ARGUMENT FOR DEFENDANT-IN-ERROR.

CHARLES E. HUGHES,
GEORGE WELWOOD MURRAY,
Counsel for Defendant-in-Error.

The Evening Post Job Printing Office, Inc., 156 Fulton St., N. Y.

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IN THE

Supreme Court of the United States,

October Term, A. D. 1918.

No. 941.

MARK EISNER, Collector of United States Internal Revenue for the Third District of the State of New York,

Plaintiff-in-Error,

AGAINST

MYRTLE H. MACOMBER,

Defendant-in-Error.

In Error to the District Court of the United States for the Southern District of New York.

STATEMENT OF THE CASE.

This is a writ of error to review the final judgment in favor of the plaintiff (defendant-in-error here) for the recovery of a tax held to be illegally assessed under the Income Tax Law of 1916.

The judgment was entered upon the overruling of a demurrer to the complaint.

The facts set forth in the complaint, and admitted by the demurrer, are in substance as follows:

On January 1, 1916, the Standard Oil Company of California had capital stock issued and outstanding to the amount of $49,686,656. On that date the Company had surplus and undivided profits, which were invested in its plant, property and business required for the purposes of the Company, amounting to $44,852,263.02. Of this sum $20,353,068.34 had been earned prior to March 1, 1913, and the balance, $24,499,194.68, subsequent to that date (Transcript, p. 3).

On January 16, 1916, the directors declared a 'stock dividend' of fifty per cent. That is, additional shares of the par value of $100 each were to be issued on the basis of one-half a new share to each old share (*id.*).

The total par value of the new shares thus amounted to $24,843,327.74, and this amount was transferred from surplus account to capital stock account. This transfer embraced all the surplus earned before March 1, 1913, and so much of the remaining surplus as was necessary to equal the total par value of the new shares. As a result, 81.9257 per cent of the par value of the new shares was charged against surplus earned before March 1, 1913, and 18.0743 per cent. of the par value of new shares was charged against surplus earned after March 1, 1913, and before January 1, 1916 (*id.* pp. 4, 5).

The plaintiff, owning 2,200 shares previous to January 1, 1916, received 1,100 of these new shares (*id.* p. 4, fol. 8). It follows that 18.07 per cent. of these shares or 198.77 shares of the par value of $19,877, were charged against surplus which had been earned after March 1, 1913, and before January 1, 1916.

The defendant, purporting to act under the authority of the Treasury Department and the Act of Congress of September 8, 1916, levied a tax on the plaintiff as having received income of this amount, that is, to the extent of $19,877, the par value of the shares in question (*id.* pp. 5, 6; fols, 10, 11). There is no question as to the basis of the assessment, as alleged, but a stipulation has been made, at the instance of the Government, to the effect that "the shares of stock which were the subject of the stock dividend", as described in the complaint, "were assessed by the Commissioner of Internal Revenue at the par value thereof" (*id.* p. 10, fol. 20).

The tax was paid under protest and appeal was taken to the Commissioner of Internal Revenue, and, this appeal having been disallowed, this action was brought to recover the money so paid.

The complaint also alleges that while the number of shares of stock owned by each stockholder was increased by fifty per cent, the market value of each share was correspondingly decreased. For the month prior to the declaration of the stock dividend and immediately thereafter, sales of the stock were made in the open market at prices ranging from $360 to $382

per share, while after the closing of the books for the stock dividend the prices ranged from $234 to $268 per share. Two of the parent shares were thus equivalent to three of the shares held subsequent to the stock dividend. It is explicitly alleged in the complaint that "the value of the capital stock owned by each stockholder, including the plaintiff's shares, was substantially unchanged by reason of the declaration of the stock dividend and the issue of additional shares of stock" (*id.* pp. 4, 5; fol. 9).

The complaint alleges that such a tax is in violation of Article I, Section 2, clause 3, and Article I, Section 9, clause 4, of the Constitution requiring that direct taxes be apportioned according to population, and that the tax is not authorized by the provisions of the Sixteenth Amendment permitting the taxation of "incomes" without apportionment.

The applicable parts of the Income Tax Law of 1916 are found in 39 Stat. 756, Ch. 463, Part I, Section 1 (*b*):

> "In addition to the income tax imposed by subdivision (a) of this section (herein referred to as the normal tax) there shall be levied, assessed, collected, and paid upon the total net income of every individual, or, in the case of a non-resident alien, the total net income received from all sources within the United States, an additional income tax (herein referred to as the additional tax) of one per centum per annum upon the amount . . ."

"For the purpose of the additional tax there shall be included as income the income derived from dividends on the capital stock or from the net earnings of any corporation, joint stock company or association, or insurance company, except that in case of non-resident aliens such income derived from sources without the United States shall not be included."

Section 2 (*a*)

". . . the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever; *Provided,* that the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value."

SUMMARY OF POINTS.

We present the following points:

(1) The tax is sought to be laid upon the property in question solely by reason of ownership and cannot be sustained unless it is authorized by the Sixteenth Amendment.

(2) The fundamental fact is that there was no gain or income to the defendant-in-error by virtue of the receipt of the additional shares constituting the 'stock dividend.' The value of the shares held by the defendant-in-error was not increased by the increase in the number of shares. The shareholder was no richer than before.

(3) The tax cannot be sustained as a tax laid upon the shareholder's interest in the undivided profits of the corporation. Apart from the serious question of the validity of such a tax, as an income tax, that was not the scheme of the Act. It is sought to lay the tax in question upon the so-called stock dividend per se, that is, upon the mere readjustment of the evidence of a capital interest already owned.

(4) So far as the present question is concerned, the word "income" in the Sixteenth Amendment has no broader meaning than the word "income" in the Income Tax Act of 1913 under which the question arose in the Towne case.

(5) Stock dividends of the sort here in question are not income within the meaning of the Sixteenth Amendment.

ARGUMENT.

FIRST. The tax is sought to be laid upon the property in question solely by reason of ownership and cannot be sustained unless it is authorized by the Sixteenth Amendment.

Before the Sixteenth Amendment there were two kinds of income with respect to taxability under the Federal Constitution.

(a) Gains and profits from "business, privileges, employments, and vocations" whether of corporations or of individuals.

Pollock v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 637.

A tax upon such gains and profits was an excise subject to the constitutional requirement as to geographical uniformity.

Pollock v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 635;
Brushaber v. *Union Pacific R. R. Co.*, 240 U. S. 1.

The Corporation Tax Act of 1909 fell within this category.

Flint v. *Stone Tracy Co.*, 220 U. S. 107.
Stratton's Independence v. *Howbert*, 231 U. S. 399.
Doyle v. *Mitchell Brothers Co.*, 247 U. S. 179, 182, 183.
Hays v. *Gauley Mountain Coal Co.*, 247 U. S. 189, 191, 192.

Similarly, under the Income Tax Act of 1913, the tax on mining corporations was found to be a true excise levied upon the results of the corporate business "in carrying on mining operations".

Stanton v. *Baltic Mining Co.*, 240 U. S. 103.

(b) Income from real or personal property, as such, taxed by reason of ownership.

The question involved in the *Pollock* case related to this sort of income, and it was held that as the tax was a direct tax Congress had no constitutional power to impose it without the required apportionment among the States according to population (Const., Art. I, Secs. 2 and 9). It was held that taxes on investments in corporate stocks, laid directly because of ownership, are in this class.

Pollock v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 637.

The Sixteenth Amendment removed the requirement of apportionment only in the case of taxes on incomes. It provides:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The history of this Amendment is well known. It was adopted for the purpose of avoiding the effect of

the decision in the *Pollock* case, and of permitting Congress to levy a tax on incomes, from whatever source derived, without apportionment.

Brushaber v. *Union Pacific R. R. Co.*, 240 U. S. 1, 18, 19.

It was, obviously, not the intention to authorize Congress to levy a direct tax on property, except as to income, or otherwise to amend, to qualify, or in any way to restrict the requirements which have existed ever since our Constitution was adopted, that direct taxes on property can be levied by Congress only if properly apportioned among the States.

That any attempt under the guise of an income tax law to levy an unapportioned direct tax on real or personal property, other than income, could not be sustained is evident from the statement in the opinion of the Court delivered by the Chief Justice in the case of *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, 19, as follows:

> "We say this because it is to be observed that although from the date of the *Hylton Case* because of statements made in the opinions in that case it had come to be accepted that direct taxes in the constitutional sense were confined to taxes levied directly on real estate because of its ownership, the Amendment contains nothing repudiating or challenging the ruling in the *Pollock Case* that the word direct had a broader significance since it embraced also taxes levied directly on personal property be-

> cause of its ownership, and therefore the Amendment at least impliedly makes such wider significance a part of the Constitution—a condition which clearly demonstrates that the purpose was not to change the existing interpretation except to the extent necessary to accomplish the result intended, that is, the prevention of the resort to the sources from which a taxed income was derived in order to cause a direct tax on the income to be a direct tax on the source itself and thereby to take an income tax out of the class of excises, duties and imposts and place it in the class of direct taxes."

See also,

Peck v. *Lowe*, 247 U. S. 165, 172.

Southern Pacific Co. v. *Lowe*, 247 U. S. 330, 335.

It is also apparent that Congress has not been authorized to coin at will definitions of "income" and prescribe that something which is not, in any true sense of the word, income shall be income for the purposes of taxation. Congress cannot by legislative fiat put a subject of a tax in a different category from that in which it properly belongs, for that would be to subject the constitutional restrictions to the legislative will.

In the present case there is no room for disputing the fact that the tax is levied upon property solely by virtue of its ownership. The Standard Oil Company of California had paid its taxes under the Corporation

Tax Act of 1909 and under the Income Tax Laws of 1913 and 1916. There is no pretense here that the present tax is laid upon the corporation, or by reason of any privilege or business of the corporation. The tax is levied upon the individual stockholder, simply because of his ownership of the shares in question. The tax upon these shares by virtue of the stockholder's ownership is, in the very nature of things, a direct tax which must be apportioned unless it can be said that these shares, issued in the circumstances we have stated, constitute income within the meaning of the Sixteenth Amendment. It is our contention that they do not.

SECOND. The fundamental fact is that there was no gain or income to the defendant-in-error by virtue of the receipt of the additional shares constituting the 'stock dividend'. The value of the shares held by the defendant-in-error was not increased by the increase in the number of shares. The shareholder was no richer than before.

The Income Tax Act of 1916 was approved September 8, 1916 (39 Stat. 756). The Act governed income received after January 1, 1916; that is, the year 1916 was the first taxable period to which the Act applied (*id.* p. 761; Sec. 8).

On January 1, 1916, Mrs. Macomber, the defendant-in-error, held 2,200 shares of the capital stock under consideration. The value of these shares as they then stood rested upon the total assets of the corporation. These assets were not segregated with respect to the company's capital as distinguished from its surplus.

The latter, quite as much as the former, was represented by investments in the business (Transcript, p. 3, fol. 6). The assets of the corporation consisted of plant, property and working capital. Mrs. Macomber's interest on January 1, 1916 (or December 31, 1915), by virtue of her ownership of the 2,200 shares, was her proportionate interest in the aggregate assets of the corporation, subject to the payment of debts.

The earnings of the corporation for the years prior to January 1, 1916 had been subject to the Corporation Tax Act of 1909 and to the Income Tax Act of 1913. Mrs. Macomber herself had been subject to the individual income tax, under the Act of 1913, upon all the taxable income she had received prior to January 1, 1916.

What remained to Mrs. Macomber as her property on January 1, 1916, after satisfaction of income taxes applicable to the period antedating January 1, 1916, constituted her capital so far as the income tax for succeeding years was concerned. Her interest as a shareholder in the aggregate assets of the corporation, as these assets stood on January 1, 1916, was a capital interest, and it is none the less to be regarded as such because, from the standpoint of corporate finance, part of the assets represented capital and part represented surplus, or because part of the surplus had been accumulated at one time and part at another time. Her capital interest on January 1, 1916, would have been no greater and no less had the corporation been or-

ganized with shares without par value as now is so frequently the case.

The question is, What has the defendant-in-error received in the year 1916 which can properly be considered to be income and hence taxable without apportionment? The Government says she has received 1,100 shares of stock. She answers that these shares of stock did not add to her wealth and in no sense constituted gain or income. The Government admits that the shares are not to be considered income so far as they are based upon surplus earned by the corporation before March 1, 1913, but that they are to be considered income to the extent of the par value of the shares that are based upon surplus earned by the corporation between March 1, 1913, and January 1, 1916. The defendant-in-error answers that this portion of the shares is no more income than the former, and that after the receipt of the shares she was left with precisely the same ownership and actual interest that she had on January 1, 1916.

This fact is not left to mere inference, however plain. It is alleged in the complaint and admitted by the demurrer. The so-called 'stock dividend' of fifty per cent. declared on January 16, 1916 (Transcript, p. 3, fol. 5) increased her number of shares from 2,200 to 3,300, but the 3,300 shares were worth no more than the 2,200. As soon as the books were closed for the stock dividend, the market value went down correspondingly (Transcript, pp. 3, 4; fols. 8, 9). The com-

plaint alleges "that the number of shares of stock owned by each stockholder was increased by fifty per cent. and at the same time the market value of each share was correspondingly decreased", and the figures are given (*id.* p. 4, fol. 9), and then follows this allegation and conceded fact:

> "That the value of the capital stock owned by each stockholder, including the plaintiff's shares, was substantially unchanged by reason of the declaration of said stock dividend and the issue of additional shares of stock" (*id.* pp. 4, 5, fol. 9).

Non constat that the defendant-in-error will ever realize even the market value of her shares as that value stood on December 31, 1915; certainly by receiving the additional shares she received no gain or income.

The contention of the Government, then, is that the defendant-in-error is to be deemed to have received in the year 1916, by virtue of the increase then effected in the number of her shares, income to the extent of $19,877, when in fact she received no gain or income whatever. The case is thus precisely like that described in *Towne* v. *Eisner,* 245 U. S. 418. There, in 1914, the corporation declared a 'stock dividend' of fifty per cent, that is, 15,000 shares in addition to the existing 30,000 shares, but it was held that these did not constitute gain or income to the shareholder for the reason thus stated by Mr. Justice Holmes in speaking for the Court (*id.* p. 426):

"'A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. . . . The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones.' *Gibbons* v. *Mahon*, 136 U. S. 549, 559, 560. In short, the corporation is no poorer and the stockholder is no richer than they were before. *Logan County* v. *United States*, 169 U. S. 255, 261. If the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417,450, the sum upon which he was taxed. It is alleged and admitted that he receives no more in the way of dividends and that his old and new certificates together are worth only what the old ones were worth before. If the sum had been carried from surplus to capital account without a corresponding issue of stock certificates, which there was nothing in the nature of things to prevent, we do not suppose that any one would contend that the plaintiff had received an accession to his income. Presumably his certificate would have the same value as before. Again, if certificates for $1,000 par were split up into ten certificates each, for $100, we presume that no one would call the new certificates income. What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new".

It is apparent that the reason that the 'stock dividend' was held not to be income in the *Towne* case was that it did not constitute income in its nature and that no governmental assertion to the contrary could alter that fact. It was because the 'stock dividend' was not income in its nature, and not because the surplus transferred to capital account had been accumulated prior to March 1, 1913, that the court was led to the decision that it was not taxable. The Act of 1913, there in question (38 Stat. 114, 166, 167) taxed income generally. If the 'stock dividend' had been income, there was nothing in the Act which could have saved it from taxation. Moreover, as it has been held by this Court, the Act of 1913 taxed dividends to shareholders although they were distributed out of earnings accumulated before March 1, 1913 (*Lynch* v. *Hornby*, 247 U. S. 339). Even though the corporation distributed, *in specie*, shares of stock of other corporations which it held in its treasury as a part of its surplus prior to March 1, 1913, the distribution thereafter and during the taxable year was held to constitute income (*Peabody* v. *Eisner*, 247 U. S. 347). In the latter case, the Court expressly distinguished such a distribution from the case of a 'stock dividend' (*id.* p. 349), manifestly because of the fact that, in the former case, a part of the corporate assets was segregated and transferred to the separate ownership of the shareholders, while, in the latter case, "the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares

and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones". (*Towne* v. *Eisner, supra.*)

If, in the *Towne* case, the 'stock dividend' in 1914 had constituted income, although it had been based on earnings accumulated before March 1, 1913, it would unquestionably have been taxable as income under the Act of 1913 (38 Stat. 167). It was not so taxable simply because it was not income for the reason stated in the opinion. The case here is precisely the same. The shares received by the defendant-in-error in 1916 were not income in their nature; she was no richer because they were received. And not being income, they were not taxable as such.

THIRD. The tax cannot be sustained as a tax laid upon the shareholder's interest in the undivided profits of the corporation. Apart from the serious question of the validity of such a tax, as an income tax, that was not the scheme of the Act. It is sought to lay the tax in question upon the so-called 'stock dividend' *per se*, that is, upon the mere readjustment of the evidence of a capital interest already owned.

It is evident that the Government chiefly relies upon the case of *Collector* v. *Hubbard,* 12 Wall. 1, but we submit that the Government can find no support in the ruling of that case for the tax attempted here.

The *Hubbard* case arose under section 117 of the Act of 1864 (13 Stat. 281, 282), which provided that

"the gains and profits of all companies", other than those otherwise taxed, should "be included in estimating the annual gains, profits or income of any person entitled to the same, whether divided or otherwise."

(1) It may be at once observed that, even if it were assumed (as we do not admit) that an interest in undivided profits of the corporation may be taxable as gain or income to the shareholder, it does not follow that additional shares *per se*, constituting a 'stock dividend', are gain or income. The proposition is a plain *non sequitur*. The two subjects are distinct. The one is an interest in undivided profits; the other is a readjustment of the evidence of an interest already owned. If the additional shares, constituting a 'stock dividend', are income *per se*, then it is unnecessary to consider whether an interest in undivided profits is or is not income. And if additional shares, as a readjustment of the evidence of an existing interest, are not income *per se*, then they do not become income because an interest in undivided profits might have been regarded as income when that interest accrued.

If shares constituting a 'stock dividend' are sought to be taxed as income *per se*, the question arises whether they can be regarded as income. On the other hand, if the tax is sought to be supported as a tax upon an interest in undivided profits, the question necessarily arises whether that is the scheme of the taxing act; whether that interest in undivided profits is, in truth, the subject of the tax and is taxable as such.

For example, in *Lynch* v. *Hornby, supra,* the shareholder's interest in undivided profits accumulated prior to March 1, 1913, was not taxed or taxable. What was taxed was the distribution of these profits in dividends and these were taxable although paid out of the prior accumulation, because they were segregated in 1914, and were then passed into the ownership of the shareholder. Similarly, in *Towne* v. *Eisner, supra,* the interest in undivided profits accumulated before March 1, 1913, was not taxed or taxable and the subsequent issue of additional shares, in 1914, was not taxable either, because these shares, unlike the moneys in the *Hornby* case or the securities distributed in the *Peabody* case, constituted a mere readjustment of the evidence of an interest already owned and did not constitute gain or income to the shareholder.

In the present case, as we deem it to be clear (for reasons hereinafter pointed out, *post,* pp. 28-33), there was no attempt to tax an interest in undivided profits. Whether or not it could have been taxed when it accrued is immaterial. It was not taxed, and, further, at the time in question it was not taxable, as from every possible point of view that interest had already become capital and was no longer, if at any time, subject to an income tax (*post,* pp. 29-30). What was sought to be taxed here was the 'stock dividend' or additional shares *per se,* and these did not constitute gain or income.

(2) It is to be noted that the endeavor of the Act of 1864, under which the case of *Collector* v. *Hubbard*

arose, was to insure the payment of the tax upon the earnings of the corporation (see *Gibbons* v. *Mahon*, 136 U. S. 549, 560). Under the Act of 1864 there were three provisions relating to taxes upon corporate earnings. Section 122 (13 Stat. 284-285) related to railroad, canal and turnpike companies and provided for a tax of five per cent upon the amount of interest, dividends or profits. After a long-standing difference of opinion[1] it was finally decided that this was essentially an excise tax on the business of the described corporations (*Railroad Company* v. *Collector*, 100 U. S. 595, 598; *United States* v. *Erie Railway Co.*, 106 U. S. 327, 330). By section 120 of the same Act (13 Stat. 283, 284) provision was made for a similar tax with respect to the earnings of banks, trust companies and insurance companies. Section 117, which was before the Court in the *Hubbard* case, related to the earnings of all other companies, that is, all companies except those above specified, and embraced the manufacturing corporations, the earnings of which were there in question. Section 117 was thus intended to reach corporate earnings not otherwise taxed. As the Attorney General said in his argument (12 Wall. p. 8), after referring to

[1] *Barnes* v. *The Railroads*, 17 Wall. 294, 309, 319; *United States* v. *B. & O. R. R. Co.*, 17 Wall. 322; *Stockdale* v. *Insurance Companies*, 20 Wall. 323, 329, 337; *Bailey* v. *Railroad Co.*, 22 Wall. 604; *Railroad Company* v. *Collector*, 100 U. S. 595; *Bailey* v. *Railroad Co.*, 106 U. S. 109; *United States* v. *Erie Railway Co.*, 106 U. S. 327, 329, 330, 331; *Memphis & Charleston R. R. Co.* v. *United States*, 108 U. S. 228, 234. See *United States* v. *Louisville & N. R. R. Co.*, 33 Fed. 829, 831, 832; *Pollock* v. *Farmers Loan & Trust Company*, 157 U. S. p. 578.

the different methods employed in these sections of the Act of 1864: "In all cases the entire annual gains and profits of every corporation, divided or undivided, seem to be within the aim and purview of the statute as objects of taxation". And as was said by Mr. Justice Clifford (*id.* p. 18): "Congress did direct that all such gains and profits, *whether divided or otherwise,* should be included in estimating the annual gains, profits, or income liable to taxation under the provisions of that act".

We find no constitutional question raised in the *Hubbard* case. The corporate earnings there in question were the earnings of the year for which the shareholder was making his return. An attempt to tax the shareholder upon his interest in undivided corporate profits accumulated in prior years, after both the corporation and the shareholder had paid all income taxes for which they were then liable, was in no way involved. The actual result was simply to tax all the gains and earnings of the corporation for the tax year. It does not appear that the *Hubbard* case was ever cited in any Federal Court, except upon questions of procedure, prior to 1917. As was said by this Court in *Southern Pacific Company* v. *Lowe,* 247 U. S. 330, 336, the decision in the *Hubbard* case was based "upon the very special language" of section 117 of the Act of 1864. And, in any event, that case furnishes no support for the tax sought to be assessed here.

(3) The point of view taken in the opinion in the *Hubbard* case is clearly indicated in the concluding sentence, in which Mr. Justice Clifford remarks:

> "Annual gains and profits, whether divided or not, are *property*, and, therefore, are taxable". (12 Wall. p. 18; italics ours.)

The same course of reasoning appears in the earlier statement of the opinion:

> "Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift, or devise" (*id.*).

This emphasis upon the fact that the interest of the shareholder in the corporate surplus was *property* is significant, and a consideration of the course of judicial opinion makes it quite evident that this was thought to be sufficient to support the tax, without drawing the distinction between what was a mere *"capital"* interest not realized, and that which could be regarded, properly speaking, as *"income"* to the shareholder. It is not too much to say that at that time a tax upon personal property (and the interest of a shareholder in the assets of the corporation is personal property), was not regarded as a *direct* tax, in the constitutional sense. Certainly, in the light of our constitutional history, it cannot be assumed that it was supposed by the Court, in deciding the *Hubbard* case, that such a tax was a direct tax and ran

counter to the constitutional provision as to apportionment. No such question was presented to the Court.

In the *Hylton* case (3 Dall. 171), it was held that a tax upon carriages, laid without apportionment, was constitutional because not a direct tax. The implications of this decision had general acceptance. When, in 1861, it was proposed to levy a direct tax, by apportionment, on personal property, a committee of the House of Representatives reported that under the *Hylton* case it could not be done (see 158 U. S. p. 710). It was pointed out in the dissenting opinion of Mr. Justice White in the *Pollock* case that the view had long been held that direct taxes in the constitutional sense only embraced taxes on real estate and capitation taxes (157 U. S. pp. 636, 639; see *Pacific Insurance Co.* v. *Soule*, 7 Wall. 433, 443; *Veazie Bank* v. *Fenno*, 8 Wall. 533, 541, 546). When the *Hubbard* case was decided it might well have been, and probably was, taken for granted in the absence of contention to the contrary that *personal property* could be taxed without apportionment, and that when it was found that the subject of the tax in that case was property, as Mr. Justice Clifford said, the argument against the tax was answered. The decision was nearly twenty-five years before the controversy and decision in the *Pollock* case.

In the *Pollock* case (158 U. S. 601) it was ruled that the word *"direct"* had a broader significance "since it embraced also taxes levied directly on personal property because of its ownership" (*Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, 19). The Six-

teenth Amendment "at least impliedly makes such wider significance a part of the Constitution" and the purpose of the Amendment was thus "not to change the existing interpretation except to the extent necessary to accomplish the result intended, that is, the prevention of the resort to the sources from which a taxed income was derived in order to cause a direct tax on the income to be a direct tax on the source itself and thereby to take an income tax out of the class of excises, duties and imposts and place it in the class of direct tax" (*Brushaber* v. *Union Pacific R. R. Co., supra*).

It now becomes necessary, as evidently it was thought not to be necessary in the *Hubbard* case, to distinguish between a tax upon *personal property* (including investments in corporate stock), which under the *Pollock* case is a direct tax, and the *income* from personal property which is taxable, without apportionment, by virtue of the Sixteenth Amendment. It is plain that the country has entered upon a permanent policy of income taxation, and it is absolutely necessary that "income" within the meaning of the Sixteenth Amendment should be distinguished from the "capital" interest of the taxpayer. In no other way, as we conceive it, can the Constitution be properly applied. The distinction between what is the property and income of the corporation, and what is the property and income of the shareholder, is a vital one.

It is evident that the interest of a shareholder, by virtue of the ownership of his shares, is a *capital*

interest. It is a single interest in the aggregate assets of the corporation subject to the payment of debts. The shareholders are not the owners of the property, profits or the invested accumulations of the corporation. The interest of each shareholder in the assets of the corporation is one that can only be enjoyed in possession in case there is a winding-up or liquidation. The fact that the value of the share interest may be greater at one time than another in no way changes the nature of the interest. The shareholder has the right to vote, to receive dividends, and on liquidation to receive his proportionate part of the surplus that may remain after debts are paid. He has the right to have the assets of the corporation properly employed in the corporate enterprise. He may transfer his right by sale. Except as he receives dividends, he has no segregated interest in corporate surplus or undivided profits. His interest, by virtue of stock ownership, is always his proportionate right with respect to the aggregate assets of the corporation, subject to the payment of all liabilities, and he has no divisible interest in the profits which the corporation holds, without distribution, and invests in its plant and business. The shareholder has simply his share, his interest, in the corporate enterprise. The corporation must, of course, pay its income tax upon its profits, but there is no income to the shareholder unless he receives it. His share interest is a "capital" interest.

When the question of the nature of the shareholder's interest in undivided profits came before this

Court in *Gibbons* v. *Mahon* (136 U. S. 549) the question was carefully considered and explicitly determined. The Court pointed out the distinction between the money earned by the corporation, and the shareholder's income, and ruled expressly that the interest of the shareholder in the accumulated earnings of the corporation, as a part of his share interest, was capital and not income, so long as the earnings were held and invested by the corporation as a part of its corporate property.

It is evident that in *Gibbons* v. *Mahon, supra,* the former expressions of this Court, including those in the case of *Bailey* v. *Railroad Company* (22 Wall. 604), had been carefully examined (136 U. S. p. 560). It was remarked that the opinion of Mr. Justice Clifford in the *Bailey* case contained "some general expressions which, taken by themselves, might seem to ignore the settled distinction, (affirmed by this court in earlier and later cases above cited,) between the property of the corporation and the interests of the shareholders". Summarizing its views, the Court said in the *Gibbons* case, speaking through Mr. Justice Gray (*id.* pp. 557, 558):

> "The distinction between the title of a corporation, and the interest of its members or stockholders, in the property of the corporation, is familiar and well settled. The ownership of that property is in the corporation, and not in the holders of shares of its stock. The interest of each stockholder consists in the right to a proportionate part of the profits whenever

dividends are declared by the corporation, during its existence under its charter, and to a like proportion of the property remaining, upon the termination or dissolution of the corporation, after payment of its debts. Van Allen v. Assessors, 3 Wall. 573, 584; Delaware Railroad Tax, 18 Wall. 206, 230; Tennessee v. Whitworth, 117 U. S. 129, 136; New Orleans v. Houston, 119 U. S. 265, 277.

"Money earned by a corporation remains the property of the corporation, and does not become the property of the stockholders, unless and until it is distributed among them by the corporation. The corporation may treat it and deal with it either as profits of its business, or as an addition to its capital. Acting in good faith and for the best interests of all concerned, the corporation may distribute its earnings at once to the stockholders as income; or it may reserve part of the earnings of a prosperous year to make up for a possible lack of profits in future years; or it may retain portions of its earnings and allow them to accumulate, and then invest them in its own works and plant, so as to secure and increase the permanent value of its property. . . .

"Reserved and accumulated earnings, so long as they are held and invested by the corporation, being part of its corporate property, it follows that the interest therein, represented by each share, is capital, and not income, of that share, as between the tenant for life and the remainderman, legal or equitable, thereof."

And, in the opinion in *Towne* v. *Eisner, supra,* referring to the 'stock dividend' there under considera-

tion and to the views expressed in *Gibbons* v. *Mahon* this Court said:

> **"Notwithstanding the thoughtful discussion that the case received below we cannot doubt that the dividend was capital as well for the purposes of the Income Tax Law as for distribution between tenant for life and remainderman. What was said by this court upon the latter question is equally true for the former."**

We submit, therefore, that the holding of the Court in the *Hubbard* case cannot be regarded as establishing the proposition that in the light of the Sixteenth Amendment the undistributed earnings of a corporation which have been invested in its plant and property and upon which the shareholder may never actually realize anything, are to be regarded as income to the shareholder. That proposition, we submit, would be wholly untenable; it would be in the teeth of any proper definition of "income" and of the established principles of law governing corporations and the rights of shareholders.

(4) There is in the present case, however, no attempt to tax an interest in undivided profits, and, in any event, the shareholder's interest in the profits of the corporation, accumulated in prior years, was not taxable. The scheme of the Income Tax Acts of 1913 and 1916 is clear.

The Act of 1913 (38 Stat. 166) did not attempt to lay any tax as against the shareholder upon an interest

in the undivided profits of the corporation, save in a single case. That case was where there was a fraudulent withholding of profits evidenced by an accumulation beyond the reasonable needs of the business and certified to be such by the Secretary of the Treasury (See *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330, 336). No such case is presented here. Apart from this exceptional case, the corporation was to be taxed on its earnings, and, for the purpose of the additional tax only, the shareholder was taxed upon his dividends. The Act of 1913 manifestly applied to all dividends that could be considered to be income (38 Stat. 167) and did not apply to so-called 'stock dividends' simply because they were not income. The Act of 1913 governed the years 1913, 1914 and 1915 and was repealed on September 8, 1916, by the new Act then approved.

The Act of 1916 (39 Stat. 756), like the former Act, did not attempt to tax shareholders upon an interest in the undivided profits of the corporation, save in the case of a fraudulent withholding certified to be such (*id.* p. 758; sec. 3). This Act was to operate for the year 1916. It had no relation to prior years. It did not attempt to tax any income for years prior to 1916, and, in the nature of things, it did not, and could not, attempt to reach any interest in the undivided profits of corporations earned in prior years. Such interests, both as to corporations and shareholders, the income taxes having been paid for the years in which the profits were earned, were certainly no longer income, or subject to taxation as income, in subsequent years, but constituted

capital with reference to the income taxes of such subsequent years. "Capital", as the Government asserted in the *Towne* case (245 U. S. p. 422), "represents the wealth or property of a person at a given instant of time." And 'capital' with reference to the Income Tax Act of 1916, and income thereunder for 1916, represents the wealth or property of a person on January 1, 1916. "Income" is what is received as such during the taxable period. What was income in 1915, and taxable as such, was no longer income in 1916, the next succeeding tax period. To hold otherwise would mean that Congress could now levy a tax of fifty per cent., or any per cent., on the income of 1914. Should Congress so attempt, it would be met by the obvious proposition that the income of 1914 had paid its tax and that the property then remaining was capital and not income with reference to a tax imposed now.

The Act of 1916, in its reference to 'stock dividends', manifestly attempted to treat such issues of shares as income *per se*. There is no basis in fact or law, we submit, for the argument that Congress was attempting to reach, or could then reach, the interest of a shareholder in undivided profits, which, if income at all, was income only in years prior to 1916. If the 'stock dividend' was income *per se*, it was taxable as such; but if it was not income, it was not taxable as such. The tax upon the shares cannot be sustained as a tax upon a previously accrued interest in undivided profits. That interest was not taxable and there was no attempt to lay such a tax.

This is clearly apparent from the following considerations:

(*a*) Congress had before it the question of taxing, as against shareholders, interests in the undivided profits of the corporation, in framing both the Act of 1913 and that of 1916. But, in each Act, such a tax was limited to the interests in undivided profits where these had been fraudulently withheld. No tax was laid upon the interests of the shareholder in undivided profits where these were properly invested in plant or were needed as working capital for the company's business. This must be deemed to be deliberate.

Now, what happened when a corporation thus invested its undivided profits? The corporation paid its annual income tax upon its earnings; and there was no tax laid upon the shareholder as to the interest in the profits thus invested. Accordingly, at the end of the tax year, what the corporation had left was its capital, so far as the Income Tax Law for the succeeding tax year was concerned. The distinction between corporate capital and corporate surplus had in that aspect no significance. Similarly, what the shareholder had left at the end of the tax year was his capital; and, so far as it represented an interest in the aggregate assets of the corporation, it was equally his capital whether these assets represented corporate capital or corporate surplus, or whether the surplus had been accumulated in the preceding year or earlier. What was subsequently taxable was what he received as income, including what his

capital might earn and what might be paid him in dividends. And Congress, in attempting to treat the subsequent 'stock-dividend' as income, did not, and could not, go back to tax what had become a capital interest.

(*b*) To treat the attempted tax on 'stock dividends' as an effort to pursue the policy of taxing interests in undivided profits, would be to impute to Congress the intent to perpetrate a gross inequity.

Corporations throughout the land have invested their surplus earnings in plants, in betterments and extensions, and employed these earnings as working capital, but the shareholders are not taxed upon their interests therein. In short, in the absence of a 'stock dividend' it is admitted that no such interest of a shareholder is taxed where the corporate surplus has been properly invested in the plant or business of the corporation. Instances of such investments of surplus are very numerous and vastly outnumber cases of 'stock dividends' which are relatively few.

If Congress had intended to tax interests of shareholders in undivided profits, assuming for the moment that Congress could do this, Congress undoubtedly would have done so. It may be supposed that, if Congress had adopted such a policy, Congress would lay that tax with a decent regard for fairness and at least would tax the shareholders in all corporations of the same class according to their respective interests in undivided surplus.

It is plain that a mere tax on 'stock dividends' would

never be laid in pursuance of a policy of taxing shareholders upon their interests in corporate surplus which had been invested in the corporate plant or business, for that would mean that, unless there was a 'stock dividend', the property sought to be reached, or the increment or gain sought to be reached, would not be taxed at all. On the other hand, such a tax laid simply in the case where a 'stock dividend' was issued would mean a grossly unequal tax reaching shareholders in only a few corporations, and which, from the standpoint of an effort to tax interests in undistributed surplus, would be obviously partial, inadequate and lacking in ordinary good sense.

Again, such an effort, limited to the case of 'stock dividends', would never reach shareholders in corporations having stock without par value. These important business corporations would be immune, and although the professed object was to reach interests in undivided surplus, these corporations might hold their surplus for business purposes to any extent without subjecting their shareholders to the tax.

The tax which Congress did lay is not to be sustained by invoking a tax which Congress did not lay or attempt to lay.

Instead of following the method of the Act of 1864, Congress taxed corporations upon their earnings and did not seek to tax shareholders upon interests in undivided surplus properly invested.

Congress undertook to tax 'stock dividends', not in

a fatuous endeavor thus to impose a tax, which would operate unequally and in a limited field, upon interests in undisturbed surplus, but in the view that 'stock dividends' or shares thus issued constituted income *per se*. If 'stock dividends' *per se* do constitute income, then Congress achieves its end; but if *per se* they do not constitute income, then Congress could not make them income by describing them as such. Congress is constitutionally debarred from taxing "capital" interests under the guise of "income", and it cannot treat that as income which is a mere readjustment of the evidence of a capital interest and makes the shareholder no richer.

The Government discloses what we cannot but regard as the fallacy of its contention when it says in its argument (Govt. brief, p. 19):

> "It must be remembered that it is not claimed that a stock dividend is always and necessarily income. The illustrations used above show that a stock dividend may be declared out of earnings and gains which had become the capital of both the corporation and the stockholder before the tax law became effective, and hence do not represent a gain accruing to the stockholder during the taxable period. The insistence simply is that such dividends are income whenever they, in fact, represent an actual gain to the stockholder during the taxable period."

In short, it is here recognized that corporate earnings may have become the capital of both the corpora-

tion and the shareholder before the tax law became effective, and hence do not represent a gain accruing to the shareholder during the taxable period; and it is said that 'stock dividends' are income whenever they do represent an actual gain to the shareholder during the taxable period and not otherwise.

But it conclusively appears that the 'stock dividend' in this case did not represent any gain to the shareholder during the taxable period.

The Government seems to think that because the Sixteenth Amendment went into effect March 1, 1913, or shortly before, that any succeeding period of years is "the taxable period."

But the Act of 1913 had its taxable periods, to-wit, each calendar year (unless there was a different fiscal year for the individual or corporation concerned), and thus there were the separate taxable periods of the year 1913, of 1914, and of 1915, under that Act. In September, 1916, Congress passed another tax law which was to govern the year 1916 and later years until changed. Within the precise limits of the Government's statement, the gains and earnings in question *had* become "the capital of both the corporation and stockholder" before the tax law in question became effective": that is, before the first tax year or period to which it related, that is, before January 1, 1916.

Nor does it make any difference when the particular tax law became effective. The point is as to the tax year, or the taxable period; and earnings or profits, or

corporate surplus, which have paid their tax for a given taxable period, become "capital" both as to the corporation and the shareholder at the end of that period, and, according to the Government's own statement, the subsequent 'stock dividend' based thereon is not income.

To repeat, the tax upon the 'stock dividend' in this case is not a tax, and cannot be a tax, upon an interest in undivided profits. It is an attempted tax upon shares, which are a mere readjustment of the evidence of a capital interest already owned and do not constitute income, and the provision of the Act could not alter that fact.

FOURTH. So far as the present question is concerned, the word "income" in the Sixteenth Amendment has no broader meaning than the word "income" in the Income Tax Act of 1913 under which the question arose in the *Towne* case.

In the *Towne* case (245 U. S. 418), the Government endeavored to dismiss the writ of error on the ground that no constitutional question was involved. The plaintiff-in-error in that case insisted that the tax law as construed by the District Court was unconstitutional. The Court held that the fact that the construction of the statute was involved did not eliminate the constitutional question, for while the Government "keeps the money it opens the question whether the Act construed as it has construed it can be maintained" (*Towne* v. *Eisner, supra*).

It is clear, however, that if a 'stock dividend' constituted income, it was taxed by the Act of 1913 which embraced "the entire net income arising or accruing from all sources" (38 Stat. 166). The text appears in the margin.[1] The Act included "dividends" without

[1] "A. Subdivision 1. That there shall be levied, assessed, collected and paid annually upon *the entire net income* arising or accruing *from all sources* in the preceding calendar year to every citizen of the United States, whether residing at home or abroad, and to every person residing in the United States, though not a citizen thereof, a tax of 1 per centum per annum upon such income, except as hereinafter provided; and a like tax shall be assessed, levied, collected, and paid annually upon *the entire net income* from all property owned and of every business, trade, or profession carrried on in the United States by persons residing elsewhere.

"Subdivision 2 (providing for the surtax).

. . . . . .

"Every person subject to this additional tax shall, for the purpose of its assessment and collection, make a personal return of his *total net income from all sources*, corporate or otherwise, for the preceding calendar year.

. . . . . .

"B. That, subject only to such exemption and deductions as are hereinafter allowed, the *net income* of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, *dividends*, securities, or the transaction of any lawful business carried on for gain or profit, or *gains or profits and income derived from any source whatever*, including the income from but not the value of property acquired by gift, bequest, devise, or descent: . . .

"That in computing net income for the purpose of the normal tax there shall be allowed, as deductions: . . . seventh, the amount received as dividends upon the stock or from the net earnings of any corporation, joint stock company, association, or insurance company which is taxable upon its net income as hereinafter provided; . . .

. . . . . .

"D. . . . *Provided further*, That persons liable for the normal income tax only, on their own account or in behalf of another, shall not be required to make return of the income derived from dividends on the capital stock or from the net earnings of corporations, joint-stock companies or associations, and insurance companies taxable upon their net income as hereinafter provided" (38 Stat. 166-168. Italics ours).

qualification and plainly covered every dividend which could be considered to be income.

It was in this view that it was held in *Lynch* v. *Hornby* that the Act reached extraordinary dividends from surplus which had been accumulated before March 1, 1913, even where the surplus embraced the increased value of the property of the corporation. While the distribution was an extraordinary one, the shareholder had received the money and it was held to be within the comprehensive words of the Act covering income from all sources. The Court expressly overruled the contention that the words of the Act of 1913 could be read in connection with the explicit provision of the later Income Tax Act of 1916 so as to exclude dividends declared out of earnings or profits which had accrued prior to March 1, 1913. The later Act of 1916 expressly excluded dividends out of earnings or profits which had accrued before March 1, 1913, but the Court held that no such qualification could be read into the broad words of the Act of 1913 (*Lynch* v. *Hornby*, 247 U. S. 344-345). The only ground for holding the 'stock dividend' in the *Towne* case not to be taxable, although the shares were issued in the year 1914 under a corporate resolution of December, 1913, was that the 'stock dividend' was not income in its *nature*. And this being so, it necessarily follows that it was just as much excluded from the authority conferred by the Sixteenth Amendment as it was from the provision of the Act of 1913. If Congress had the power to tax the 'stock dividend', because

the 'stock dividend' was *income,* there is no escape from the conclusion that it did tax it in the Act of 1913. And, if the 'stock dividend' in the *Towne* case was not within that Act, it was only by virtue of the fact that it was not income in truth. The Court had jurisdiction to determine the meaning of the word 'income' both as used in the statute and as used in the Constitution, but in determining that the 'stock dividend' did not fall within the description of income, it based its conclusion upon reasoning which had no reference to the special time or circumstance of the statute but to the nature of the property itself, and its conclusion that the 'stock dividend' was not income was thus based upon a ground applicable both to the Constitution and to the statute. In fact the statute was enacted immediately after the Sixteenth Amendment was adopted and manifestly with the same intent.

And here it may be pertinent to observe, with respect to the decision in *Swan Brewery Company, Limited,* v. *The King,* Law Reports [1914] A. C. 231, that the Dividends Duty Act of 1902 of Western Australia, there under consideration, was in this respect like our Income Tax Act of 1913. The Australian Act of 1902 taxed "dividends" as our Income Tax Act of 1913 taxed "dividends". Similarly, the Massachusetts Act, which was the subject of decision in *Tax Commissioner* v. *Putnam,* 227 Mass. 522, arose under a statute which used the term "dividends" without any special mention of 'stock dividends' and the Court referred in its opinion to the provisions of the Federal Income Tax Act of

1913 (*id.* p. 528), the statute being similar, so far as the present question is concerned. The decision in the *Swan Brewery* case was rendered over three years before, and the decision in Massachusettts six months before, the decision of this Court in *Towne* v. *Eisner.*

These earlier decisions, cited by the Government, can in no way affect the decision or reasoning of this Court in the *Towne* case, for this Court rested its decision on the fundamental and clear proposition that that was not income which left the shareholder no richer than before, but merely readjusted the evidence of an interest already owned,—a proposition which the Courts upon whose decisions the Government relies saw fit to ignore.

FIFTH, 'Stock dividends' of the sort here in question are not income within the meaning of the Sixteenth Amendment.

In view of the explicit ruling of this Court as to the nature of a 'stock dividend', we should suppose that the question was no longer open to argument. But in view of the statements contained in some of the opinions of other courts, which the Government cites, we shall briefly review the considerations which, as we view it, lead to the conclusion that 'stock dividends' are not income. And if they are not income in the sense that they make the shareholder richer than he was before, it can hardly be contended that they should be regarded as income within the meaning of the constitutional provision.

The situation here presented is a typical one and the facts to which the question is addressed are familiar.

A corporation is not bound to distribute all its earnings in dividends. The directors may properly decide to use a portion of the earnings for the development of business, for the extension of plant, for betterments and for working capital. The undivided surplus of a corporation is not, normally, idle money; it is, normally, invested money. It is money invested in property, or embarked in the corporate enterprise; that is the reason it is not paid out in dividends. If the directors have not transcended the broad limits of their judgment, the shareholders cannot complain because earnings are invested instead of being distributed.

The interest of the shareholders, with respect to the property of the corporation, is not an interest in the segregated portion representing the original subscriptions; it is not an interest limited to an amount equal to the par value of their shares; it is not an interest limited to any particular portion of the corporate property, in the absence of special charter provisions, but is simply an interest in all the corporate assets. When these assets are swelled by the addition of undivided profits, the interest of the shareholders in these accumulations is precisely the same as their interest in any other property of the corporation. "The property of every company may consist of three separate distinct things, which are its capital stock, its surplus, its fran-

chise; but these three things, several in the ownership of the company, are united in the ownership of the shareholders. The share stock covers, embraces, represents all three in their totality, for it is a business photograph of all the corporate possessions and possibilities. (*People ex rel. Union Trust Co.* v. *Coleman*, 126 N. Y. 433, 438.)

When dividends are declared the amounts of the dividends are separated from the corporate property and are received by the shareholders respectively as their separate property. But until dividends separating money or property from the corporate assets in this way are declared, the shareholders continue to retain the interest in all these assets represented by their stock, the extent and value of their aggregate interests depending not upon the sums originally contributed to capital, but upon the extent and value of all the assets of the corporation, including its accumulations, after deducting liabilities. When a so-called 'stock dividend' is declared, the company does not distribute but continues to hold the property upon which the stock issue rests. Its undivided profits previously invested in the enterprise continue to be so invested. Instead of being a "dividend" in any proper sense, the effect of the action is that there shall be no dividends of the accumulations capitalized. The aggregate interests of the shareholders remain unchanged and their proportional interests remain unchanged.

Thus, a 'stock dividend', or increase of capital

stock against surplus accumulations, accomplishes two things:

(1) The amount represented by the 'stock dividend' is permanently classified so that it cannot be paid out as dividends.

(2) The number of shares is increased without affecting the title of the corporation to any part of the corporate property and without adding to the ratable interests of the shareholders.

Upon a liquidation immediately before the 'stock dividend' the shareholder would have received precisely the same amount as he would have received upon a liquidation immediately after the 'stock dividend'. So far as the paper, or stock certificate, issue is concerned, it is an evidence of an interest already owned and permanently capitalized.

These plain incidents of the transaction have been repeatedly and authoritatively described.

> "The corporate property remains the same after the stock is increased as before, and the interest of each stockholder in the corporate property is also unchanged."
>
> *Kaufman* v. *Charlottesville Woolen Mills Co.*, 93 Va. 673, 675.

> "After a stock dividend a corporation has just as much property as it had before . . . After such a dividend the aggregate of the stockholders own no more interest in the corporation

than before. The whole number of shares before the stock dividend represented the whole property of the corporation, and after the dividend they represent that and no more. A stock dividend does not distribute property, but simply dilutes the shares as they existed before."

Williams v. *Western Union Telegraph Co.*, 93 N. Y. 162, 189.

"There is a clear distinction between the ordinary cash dividend, no matter when earned, and a stock dividend declared as in the case at bar. The one is a disbursement to the stockholder of accumulated earnings, and the corportion at once parts irrevocably with all interest therein. The other involves no disbursement by the corporation. *It parts with nothing to the stockholder.* The latter represents not an actual dividend, but certificates of stock which evidence in a new proportion his interest in the entire capital, including such as by investment of accumulated profits has been added to the original capital."

DeKoven v. *Alsop*, 205 Ill. 309.

"It is the characteristic feature of a stock dividend that the property of the corporation itself remains unchanged, but that each one of the new shares of the increased capital stock represents a smaller fractional interest than before in the total amount of the corporate property. On the other hand it is the characteristic feature of a dividend declared and paid wholly from the net profits or undivided earnings that it does

diminish the property of the corporation by exactly the amount of the dividend so paid out, while it leaves the fractional interest represented by each share of the capital stock exactly what it was before. *Gibbons* v. *Mahon*, 136 U. S. 549, 559, 560."

Gray v. *Hemenway*, 212 Mass. 239.

"The word 'dividends', if unqualified, signifies dividends payable in money. The word 'income' has a broader meaning, but hardly broad enough to include things not separated in some way from the principal. It is not synonymous with 'increase'. The value of stock may be increased by good management, prospects of business, and the like. But such increase is not income. It may also be increased by accumulation of surplus; but so long as that surplus is retained by the corporation, *either as surplus or as increased stock*, it can in no proper sense, be called, income."

Spooner v. *Phillips*, 62 Conn. 62, 68. (Italics ours.)

"It is also one of the incidents of a stock dividend that the stockholder, who receives his pro rata proportion of the new issue while he acquires the ownership of more shares, adds nothing to his proportionate ownership of the assets of the corporation. His holding, after the new issue, bears precisely the same ratio to the total of the outstanding shares of the corporation as did his previous holding to the previous total. *Terry* v. *The Eagle Lock Co.*, 47 Conn. 141, 165. The underlying idea of a cash dividend, on the

other hand, is the distribution to shareholders, as the rewards of the corporate enterprise, of a portion of the profits or surplus assets of the corporation. . . . Whatever form the distribution takes, the result always is the reduction of both the corporate assets and surplus by just the amount of the distribution. Something is taken from the corporation and given to the stockholders. That which is distributed becomes released from all corporate control and comes under the dominion of the shareowner."

Green v. *Bissell*, 79 Conn. 547, 551.

See also,

Terry v. *Eagle Lock Co.*, 47 Conn. 141.

Brinley v. *Grou*, 50 Conn. 66.

Bouch v. *Sproule*, 12 App. Cas. 385.

Jones v. *Evans* (1913), 1 Ch. 23.

In re *Carson*, Irish Reports (1915), Vol. I, p. 321.

Guinness, Trustee, v. *Guinness*, Cases Ct. of Session, 5th Series, Vol. 6, p. 104.

Minot v. *Paine*, 99 Mass. 101.

Davis v. *Jackson*, 152 Mass. 58.

D'Ooge v. *Leeds*, 176 Mass. 558.

Hyde v. *Holmes*, 198 Mass. 287.

Brown v. *Larned*, 14 R. I. 371, 373.

Billings v. *Warren*, 216 Ill. 281.

Lancaster Trust Co. v. *Mason*, 152 N. Car. 660.

Great Western Mining &Mfg. Co. v. *Harris*, 128 Fed. 321, 326.

A genuine dividend constitutes a debt between the corporation and the shareholders;[1*] once declared it may not be rescinded [2*] and an action may be brought on the debt.[1*]

It is otherwise with a stock issue made to shareholders (commonly called a 'stock dividend'), for, as the directors do not divide anything and in substance merely readjust the symbols by which the shareholders own the net assets, they may recall their own action and leave the shareholders without grievance.

In *Staats* v. *Biograph Co.*, 236 Fed. 454, the Circuit Court of Appeals for the Second Circuit, holding that the action of a board of directors in declaring a 'stock dividend' might be rescinded, said (p. 457):

> "In this case it does not escape observation that the plaintiff's right to a stock dividend, if he has such a right and can enforce it, would gain him nothing. We say it would gain him nothing, because, while a stock dividend would increase the number of his shares, it proportionately diminishes the value of each of his shares, leaving the aggregate value as it was before. He acquires the ownership of more shares, but he adds nothing to his proportionate ownership of the assets of the corporation."

The case of *Gibbons* v. *Mahon*, 136 U. S. 549, was one of a will bequeathing stock in a corpora-

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[1*] *King* v. *Paterson*, 29 N. J. L. 504; *Hunt* v. *O'Shea*, 69 N. H. 600; *Lockhart* v. *Van Alstyne*, 31 Mich. 76; *Stoddard* v. *The Shetucket Foundry Co.*, 34 Conn. 542.

[2*] *Beers* v. *Bridgeport Spring Co.*, 42 Conn. 17; *Staats* v. *Biograph Co.*, 236 Fed. 454.

tion and government bonds in trust to pay "the dividends of said stock and the interest of said bonds as they accrue" to a daughter of the testator, and directing that upon her death "the said stocks, bonds, and income shall revert to the estate" of the trustee. The corporation accumulated earnings from time to time, before and after the death of the testator, which were invested in its permanent works and plant. It declared a 'stock dividend' representing these accumulated earnings and the question was whether this 'stock dividend' was income. It was held to be capital and that it should go to the remainderman, only the dividends which might be received on such stock being payable to the tenant for life.

After reviewing the authorities of other jurisdictions, Mr. Justice Gray discussed the nature of a 'stock dividend' (*id.* pp. 559, 560, 569):

> "Therefore, when a distribution of earnings is made by a corporation among its stockholders, the question whether such distribution is an apportionment of additional stock representing capital, or a division of profits and income, depends upon the substance and intent of the action of the corporation, as manifested by its vote or resolution; and ordinarily a dividend declared in stock is to be deemed capital, and a dividend in money is to be deemed income, of each share.
>
> **"A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not**

diminished, and their interests are not increased. After such a dividend, as before, the corporation has the title in all the corporate property; the aggregate interests therein of all the shareholders are represented by the whole number of shares; and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of new ones. . . .

"The resolution is clearly an apportionment of the new shares as representing capital, and not a distribution or division of income. As well observed by Mr. Justice James, delivering the opinion of the Court below: 'Certificates of stock are simply the representative of the interest which the stockholder has in the capital of the corporation. Before the issue of these two hundred and eighty new shares, this trustee held precisely the same interest in this increased plant in the capital of the corporation, that she held afterwards. She merely had a new representative of an interest that she already owned, and which was not increased by the issue of the new shares. A dividend is something with which the corporation parts, but it parted with nothing in issuing this new stock. It simply gave a new evidence of ownership which already existed. They were not in any sense, therefore, dividends for which this trustee had to account to the *cestui que trust*. She stood after the issue of the new shares just as she had stood before; and the

> trustee was obliged to treat them just as she did, namely, as a part of the original, and to pay the dividends to the *cestui que trust*'."

Gibbons v. *Mahon* was long held under advisement by the Court, and it is apparent that it was decided after the most thorough consideration. We have quoted at length from the opinion, because the *ratio decidendi* renders unavailing the efforts which have been made to distinguish this case. The Court explicitly rested its decision upon *the essential nature* of the transaction—that is, upon a consideration of the essential quality of a 'stock dividend' based there, as here, on accumulated surplus invested in plant and property and by appropriate resolution permanently classified as capital. The opinion makes it clear that it was not a rule particularly applicable to wills, or trusts, but the nature and effect of the corporate action which determined the conclusion of the Court. If the 'stock dividend' was not receivable as income, when if income the claimant would have been entitled to receive it, it could hardly be said that it should be taxed as income. Had it been income, the *cestui que trust* would have succeeded, but because the Court considered it *not* to be income she lost her suit. If the 'stock dividend' was not income for the purpose of distribution to the beneficiary of the income, we cannot conceive that it could have been regarded, had an income tax law been in operation, as income for the purpose of taxing it.

As already stated, the statements which had been made in the case of *Bailey* v. *Railroad Co.* (22 Wall. 604), to which the Government refers, were carefully considered in the *Gibbons* case.

Gibbons v. *Mahon* was an exposition by which the final authority defined to this extent, by exclusion, the meaning of "income". The usual rule is that when a word which has received judicial construction is subsequently used in Federal legislation it should be presumed to have been used in the sense determined by the Court (*Kepner* v. *United States,* 195 U. S. 100, 124; *Latimer* v. *United States,* 223 U. S. 501, 504). The same principle may be applied in construing the Sixteenth Amendment. If there is to be resort to judicial definitions or expositions with respect to what is "income" as distinguished from "capital", we can think of no justification for ignoring the deliberate ruling of this Court. It is to be observed that State decisions, which are invoked for a contrary rule, almost invariably turn on an effort to effect the intention of the testator, or donor in a trust, with respect to the disposition of his property. Rarely are these decisions concerned with the question of what is income in its nature. And there has been a general agreement that 'stock dividends' declared during a trust life estate, which are based on earnings made by the corporation prior to the creation of the trust, are not income,—a position fatal to the contention that stock dividends are income *per se.* (See *Matter of Osborne,* 209 N. Y. 450, 477; *Day* v. *Faulks,* 81 N. J.

Eq. 173.) Thus, in the *Matter of Osborne, supra,* cited by the Government, it was said that to give a 'stock dividend' to the life tenant which was earned prior to the creation of the trust would "shock the sense of justice". But, of course, there would be nothing that was at all shocking if the stock dividend was income *per se* and the life tenant was therefore entitled to it.

It would be extraordinary to disregard the explicit decision, as to what is income, made by this Court before the adoption of the Sixteenth Amendment, and to substitute therefor State views as to the intention of testators.

Moreover, if Congress is authorized to deal in a particular manner with "black", it cannot deal in this manner with "white" by calling it "black". However important the legislative taxing word, it cannot extend a constitutional provision. It cannot add a cubit to a man's stature or a dollar to his income. It is enough to tax one upon what he has received, but if he is to be taxed upon what he has not received, and may never receive,—upon what in truth makes him no richer,—then we submit that some other word must be found to justify this unhappy result than the word "income".

It is frequently said that the shareholder secures new rights or advantages. But the contention will not bear analysis. We are concerned here with the *property interest* represented by the stock in question upon which the plaintiff had been taxed. This stock represents (1)

the right to have the corporate property managed according to the fundamental compact or contract of membership; (2) the right to receive dividends, when duly declared, that is, amounts separated from the corporate assets and vested in the shareholders individually; and, (3) the ratable interest in the aggregate of the corporate assets to which the shareholders would be entitled upon liquidation.

With respect to management, the shareholder's rights are unchanged save to the extent that the accumulated surplus, which is represented by the new stock, is no longer subject to the discretion of the directors in distribution but is classified as capital and must be retained by the corporation as such.

With respect to dividends that may be declared upon this stock,—whenever any such dividend is declared and there is thus segregated from the corporate property an amount which the shareholder receives, he will be taxable accordingly.

With respect to the right to receive his ratable interest upon a winding-up, there is no change.

It is argued that the effect is the same as though a cash dividend had been declared, and its amount received by the defendant-in-error, and she had then invested this amount in the new stock. The same argument was made unavailingly in *Towne* v. *Eisner*. It is manifest that the two things mentioned, instead of being the same, are different, both legally and practically. When the cash dividend is declared and the amount is received, the shareholder obtains something which he

owns and which he may reinvest or not as he pleases. He receives property in his exclusive ownership, and he exercises the freedom of choice. In the case of a 'stock dividend', he obtains nothing but an evidence of what he already owns; he has no freedom to invest or not invest; and the investment is permanently capitalized. This distinction was pointed out in *Davis* v. *Jackson*, 152 Mass. 58.

It is argued further that the certainty that these earnings of the corporation could thenceforth never be distributed as dividends, was a valuable assurance of the continued solvency of the company to the stockholder, and that this assurance was subject to a tax as income of the individual shareholder. But before the 'stock dividend' the shareholder's interest in the corporate assets could not be taken away, except through mismanagement or losses, and his interest continues to be subject to these contingencies as before. Previously, if there were distribution in cash, he would receive his dividend and own the amount. The proposition that the certainty that a man will never receive a given fund is equivalent to his actual receipt of that fund will appeal less to the shareholder's sense of logic than to his sense of humor.

Nothing could be a greater fallacy than to treat a recipient of a 'stock dividend' as being in the position of a recipient of a like amount of cash. In fact, he may never receive anything but a piece of paper, for the corporation may become insolvent and his stock worthless. In the present case, the shares had a

market value and, as might be expected, the market value of all the shares remained unchanged. But it may be, and frequently is, the case that at the time of the 'stock dividend' the shares do not have a market value, or have a market value below par. The corporation may have a surplus, and may capitalize it, but it may be engaged in a hazardous enterprise or for other reasons its shares may not have a value corresponding to their book value. Illustrations of this may readily be found. There are to-day selling on the New York Stock Exchange shares which are below par, although the corporation has a surplus and could issue 'stock dividends'. Such 'stock dividends' would not only make the shareholders no richer, but the latter would have to pay a tax, under the contention of the Government, as an income tax upon an assumed or par value which was greater than the actual value of the shares themselves. The fact that the corporation may have accumulated profits, or surplus, does not mean that the shareholders can realize that amount. It is a misnomer to call 'stock dividends' a *distribution;* it is not a distribution but a capitalization. The capitalization of surplus does not transfer it to shareholders. If the new shares have market value, the 'stock dividend' will make the shareholders no richer, and, if the shares have no market value, the shareholders will not be able to realize even that which they are falsely assumed to have received.

The argument that a 'stock dividend' is income fails to distinguish between the effect of the dollar

sign printed on the certificates of stock as indicating the amount contributed to "capital", and the interest of the shareholder in the aggregate corporate assets, with which this dollar sign, or the par value of his shares, has nothing to do. As to the corporation, its net assets are divided into two groups, "capital" and "surplus", with different legal attributes, and the dividing line between the two groups is shown by the nominal or par value of the company's stock, or the amount of the contributed "capital".

In the case at bar, for example, the Standard Oil Company of California had $49,686,656 of capital stock, and $94,538,919. of assets. The $49,686,656 of capital was divided into 496,866 shares of the par value of $100. each. These $49,686,656 represented, in a general sense, a trust fund to be used by the corportion in the conduct of its business and for the payment of its debts; none of it could lawfully be separated from the company and paid to its shareholders. The other $44,852,263. of its assets represented surplus which the company was free to dispose of in any manner that it saw fit. There were 496,866 shares of stock outstanding; the dollar mark on each certificate, indicating the par value of each share, was of importance in indicating the amount of the contributed capital stock, and therefore the dividing line between these two groups of its net assets.

But there was no such distinction with regard to the shareholder's interest in the aggregate corporate assets. As to this the dollar mark on his certificate

was immaterial. Each share of stock represented 1/496,866 part of the net assets of the corporation, and those assets might amount to $1,000,000. or $50,000,000, and this was true whether his stock had a nominal par value or whether, as is permitted in various States, it was "no par value" stock.

When it is argued that in receiving a 'stock dividend', a shareholder receives from the corporation something of value which must therefore be income, there is an inaccuracy in terms. If I exchange a two-dollar bill with the money changer for two one-dollar bills, I have, it is true, received from him something of value, but my property interest remains entirely unchanged, and I have surely not received any "income".

If the Standard Oil Company of California had outstanding 496,866 shares of capital stock of the nominal or par value of $100. each, and had issued in exchange therefor 993,732 shares of the nominal or par value of $50. each, each shareholder would have received an increased number of tangible evidences of his ownership in the assets of the corporation. He would have no greater interest in the assets of the corporation than he had before, and the dividends he might thereafter receive on his holdings of $50. shares would be just as large as if he received dividends on his original $100. holdings. But the Government would not contend that such an alteration of the shareholder's certificates constituted income.

It undoubtedly will be conceded by the Govern-

ment that if a corporation having a million dollars of capital and with no surplus, waters its stock and issues a 50 per cent. 'stock dividend' to its shareholders, the new stock, not representing an increase of assets, would not constitute taxable income in the hands of the shareholder; the receipt by the shareholder of certificates of stock having an increased nominal or par value does not increase the stockholder's real interest in the corporation, and therefore the change does not constitute income.

The effect of this concession cannot be overcome. It is conceded that the increase of the number of shares into which the assets of the corporation are divided, or the issue of a new series of fractional certificates, does not constitute income to the shareholder if the corporation has no accumulated surplus, even though the nominal or par value of the shares of stock owned by each shareholder is thereby increased. It is conceded that mere increase in the number of shares into which the capital of a corporation is divided does not constitute income, and this regardless of the question whether the corporation has available accumulated surplus or not. And it is just as true that the shareholder's interest in the aggregate corporate assets remains unchanged when there is an increase of stock based on accumulated surplus. The change is simply that the amount is permanently capitalized so that it cannot be distributed without liquidation; on liquidation the shareholder would receive no more than before.

Of course the salability of the new shares presents no more argument for the existence of "income" than does the salability of the old shares at an increased price because of the accumulated earnings back of them. A sale in either case would have the same effect.

If one had 9,000 shares previously, and received 4,500 additional shares through a 'stock dividend' based on surplus accumulations, he of course, could sell any portion of the total 13,500 shares. And if he sold 4,500 of the 13,500 shares he would receive the equivalent in cash. But he could have realized the same amount prior to the 'stock dividend' by selling 3,000 shares of his original 9,000 shares. His intrinsic interest is the same, and the transaction has not affected its value.

The Government says that " 'income' represents the advantage, service or use actually rendered by 'capital' to its owner during a period of time". Such a definition leads one quite afar. Thus a very important 'service' or 'advantage' of capital, which every business man would be swift to recognize, is the advantage or service that it gives in enabling him to have a line of credit at his bank. He gives his bank a statement of his resources and he is allowed a line of credit "during a period of time". If, at the end of this 'period' he is able to make good his obligations but has no gain, it would strike him as extraordinary to say that this line of credit constituted 'income' on which he should pay a round sum to the Government

through an income tax. Perhaps, following the analogy of the present case, if a man had a line of credit for a year of $100,000 he should pay an income tax upon this 'advantage' or 'service' of his capital as amounting to $100,000.

A better definition, which embraces the essential element of *'gain'*, is found in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415, where it is said:

> "'Income' may be defined as the gain derived from capital, from labor, or from both combined."

This definition was reaffirmed in *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 185, where it is said that

> "Whatever difficulty there may be about a precise and scientific definition of 'income', it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities. As was said in *Stratton's Independence* v. *Howbert*, 231 U. S. 339, 415: 'Income may be defined as the gain derived from capital, from labor, or from both combined.'"

Or, it may be said, quoting the language of Professor Seligman:

> "Strictly speaking, income as contrasted with capital denotes that amount of wealth which flows in during a definite period and which is at the disposal of the owner for purposes

> of consumption, so that in consuming it, his capital remains unimpaired." (Seligman on Income Tax, p. 19.)

Of course it is not denied that income may be in the form of property, although it is well settled that in construing an Income Tax Act income is taken to mean money in the absence of any special provision of law to the contrary, and not the mere expectation of receiving it (*United States* v. *Shillinger,* 14 Blatchf. 71). If, however, the Act reaches property and not simply money, it must still be property that constitutes *'gain'* or, *'income'*. It is not 'income' simply because it is property.

The Courts have always recognized that mere appreciation in value of capital assets is not to be called income.

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital."
>
> *Gray* v. *Darlington,* 15 Wall. 63, 66.*

*Under the British Income Tax Act (16 & 17 Vict. c. 34) it is established that applications in value of capital assets, even after the realization of profits by sale, do not constitute taxable income except in cases of transactions by dealers or other persons who buy and sell for purposes of profits. *Tebrau (Johore) Rubber Syndicate, Limited,* v. *Farmer,* S. T., 5 Income Tax Cases, 658; *Stevens* v. *The Hudson's Bay Company,* 5 Income Tax Cases, 424; *The Assets Company, Ltd.* v. *The Inland Revenue,* Cases in the Court of Session, 4th Series, Vol. 24, p. 578.

In the words of Mr. Justice McKenna in *Lynch* v. *Turrish*, 247 U. S. 221, 231, speaking with approval of *Gray* v. *Darlington*:

> "Indeed, the case decides that such advance in value is not income at all, but merely increase of capital and not subject to a tax as income."

In the case of the *Baldwin Locomotive Works* v. *McCoach* (3 C. C. A. 1915), 221 Fed. 59, which arose under the Corporation Tax Law of 1909, which measured the tax by the income of the corporation, the Court said:

> "We agree with the District Court that this increase of valuation was not income within the meaning of the statute. Nothing whatever was added to the corporate property, which remained exactly the same after the appraisement as before. The only thing done was to put upon the company's books an expression of expert opinion that certain property was worth a certain sum, and this can hardly be said to be income, or even gain, in any proper sense. The company could not become either richer or poorer by making a few book entries that merely recorded a new estimate of how much it was worth."

Exactly the same situation is presented when the market value of a share of stock increases because of accumulated earnings. Until *separation* takes place, which happens when a cash dividend is declared, there is no taxable income. Again the courts have recognized that such appreciation is not income, for nothing

has come in, part of which can be taken by the government for revenue purposes.

In *Lynch* v. *Hornby*, 247 U. S. 339, the Court said, through Mr. Justice Pitney, in reference to the undivided surplus:

> "As to these, however, just as we deem the legislative intent manifest to tax the stockholder with respect to such accumulations only if and when, and to the extent that, *his interest in them comes to fruition as income,* that is, in dividends declared" (p. 343; italics ours).

Finally, the same reason exists for holding that 'stock dividends' shall not be included within the term "income". It is not necessary to show again what happened when the Standard Oil Company of California declared its 'stock dividend', it is merely sufficient to show that the defendant in error has not received anything with which to pay the tax. She has received new shares but her old shares represented precisely the same value; in fact she is no richer at the end of the year than at the beginning; and as in all the cases discussed above, the one thing necessary has not taken place—realization of gain. She may never realize any gain. Whether she does or not will depend on the ultimate liquidation so far as the shares themselves are concerned. If dividends are received *on* the new shares, so that she does receive gain in this way, she will be taxable on such dividends. But until that point is reached the plaintiff is immune from taxation under an income tax

law. She objects to the payment of a tax as having received some income when just the opposite thing has happened—she has been definitely assured that she will not receive it.

It is submitted therefore that when Congress was authorized to tax "incomes" it was not the intention to allow it to tax a change in the evidence of ownership which is all that a 'stock dividend' represents.

It is submitted that the judgment of the District Court should be affirmed.

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No. 318.

IN THE

SUPREME COURT OF THE UNITED STATES,

OCTOBER TERM, A. D. 1919.

MARK EISNER, COLLECTOR, ETC.,
Plaintiff-in-Error,

against

MYRTLE H. MACOMBER,
Defendant-in-Error.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

SUPPLEMENTAL BRIEF

FOR DEFENDANT-IN-ERROR.

ON REARGUMENT.

CHARLES E. HUGHES,
GEORGE WELWOOD MURRAY,
Counsel for Defendant-in-Error.

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Undivided Corporate Profits are not Income to the Stockholder. 15

'Stock Dividends' do not constitute Income. Income is the gain, come to fruition, from Capital, from Labor, or from both combined. This is sound doctrine both in law and in economics. *a.* Income of a corporation is not income of a shareholder until distributed. *b.* A 'stock dividend' is not income. It does not constitute a distribution of anything; it is a mere readjustment of capital. 36

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IN THE

SUPREME COURT OF THE UNITED STATES,

OCTOBER TERM, A. D., 1919.

No. 318.

MARK EISNER, Collector of United States Internal Revenue for the Third District of the State of New York,

Plaintiff-in-Error,

AGAINST

MYRTLE H. MACOMBER,

Defendant-in-Error.

In Error to the District Court of the United States for the Southern District of New York.

SUPPLEMENTAL BRIEF FOR DEFENDANT-IN-ERROR ON REARGUMENT.

In this supplemental brief, we shall address ourselves directly to the position taken by the Government on this re-argument.

The pith of the Government's contention.

The pith of the Government's contention is that the Act of 1916 did not tax 'stock dividends' *per se* (Government's Supplemental Brief, p. 21), but that the tax is to be supported as one laid, in substance, upon the stockholder's interest in corporate earnings as constituting income to the stockholder although the earnings are undivided, and that the so-called 'stock dividend' is "a mere change in form of that which already belonged to the stockholder" (*id* pp. 15, 34, 35). The Government concedes that "what was not income before is not income after a stock dividend" (*id* p. 15); insists that the 'stock dividend' is merely a "new dress" in which the stockholder's previous interest appears (*id.* p. 16); and then states its position succinctly as follows:

> "The Government claims the right to tax gains when wearing a new dress only when they were taxable in their old dress."

The Government's supplemental brief breathes the conviction that unless the tax in question can be sustained on this theory, which is reiterated throughout the argument, it cannot be sustained at all. The Government frankly jettisons the argument that "*from the very nature of a stock dividend*, its declaration *per se* confers such advantages upon the stockholder as to make the new stock a legitimate item of income without regard to when the earnings thus converted into stock may have accrued" (*id.* p. 29.)

The Government recites its argument as urged in the *Towne* case[1] only to abandon it. (*id.* pp. 29-32). It is recognized that the 'stock dividend' cannot be considered to be income because of any advantages inhering in the 'stock dividend' itself (see *infra*, p. 48). The Government states that the controversy in the *Towne* case was narrowed to the single question "whether there was anything in the nature of a stock dividend which, without more, made it income, that is, whether the mere declaration of a stock dividend conferred such advantages upon the stockholder as to render the dividend an item of taxable income" (*id.* pp. 30, 31). It was that question which the Government says was decided (*id.* p. 31). And, the Government adds that "as applied to a case in which the right to tax depends upon the *mere declaration of the dividend*", the Government finds no fault with the statement as quoted in the *Towne* case from *Gibbons* v. *Mahon*, 136 U. S. 549, 559, as follows (Govt's. Supp. Brief, pp. 31, 32).

> "A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased * * * and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional in-

[1] *Towne* v. *Eisner*, 245 U. S. 418.

terest that the original shares represented before the issue of new ones."

The Government then concedes that as a statement of "the actual effects and results of the act of declaring a stock dividend, this is undoubtedly accurate" (*id.* p. 32). The Government, as it seems to us, could do no less, for it has been distinctly held by this Court that cash dividends, or dividends of property *in specie* declared after March 1, 1913, although out of profits accumulated prior to that date were taxable income (*Lynch* v. *Hornby* 247 U. S. 339; *Peabody* v. *Eisner*, 247 U. S. 347), and there seems to be no escape from the conclusion that if a 'stock dividend' constituted income *per se*, the fact that the profits capitalized in the *Towne* case had accrued before March 1, 1913, would not have constituted a sound distinction. Being well aware of this, and conceding the undoubted accuracy of the statement above quoted as "to the actual effects and results of the declaration of a stock dividend" the Government reaches the conclusion under the *Towne* case "that, in the absence of the fact that profits being distributed are themselves taxable and the time of their taxation has been postponed until the moment of their capitalization, a stock dividend is not income" (*id.* p. 32).

The importance of this is obvious. We no longer need to address ourselves to the arguments based on alleged advantages or new rights inhering in the additional shares constituting the 'stock dividend.' That position the Government sees to be wholly untenable.

The Government's present contention then is, not that the 'stock dividend' is taxable as constituting income in itself but as the form or garb of a previous interest in the undivided corporate profits of the corporation which the Government contends was taxable as constituting income to the stockholder.

We may quote again from the Government's supplemental brief with respect to the nature of a 'stock dividend.' The Government does not wish to be considered as being under any delusion as to the matter. The Government says (*id.* p. 15).

> "It is, of course, conceded that this transaction does not, of itself, make the stockholder richer than he was before. The Government readily agrees that there has been a mere change in form of that which already belonged to the stockholder and that what was not income before is not income after a stock dividend."

And, while a good deal is said in the Government's supplemental brief as to "distribution", it is finally conceded that "it may be more accurate to speak of a stock dividend as readjusting the evidence of ownership of undivided profits rather than as distributing such profits." (*id.* p. 42). Of course, the true import of this concession is not obscured by its form. Obviously, it not only "*may be*" but it *is* more accurate to speak of a 'stock dividend' as readjusting the evidence of ownership, that is, of the proportional interest in all the shares of stock represented, rather than as a distribution of undivided profits.

Contending that the stockholder's interest in the undivided profits of the corporation constitutes income to the stockholder, the Government insists that Congress has used 'stock dividends' to measure the amount of the stockholder's gains and to indicate the form in which such gains shall be taxed (*id* p. 21). The Government says that, through the 'stock dividend,' the interest in the undivided corporate earnings has merely undergone a "change of form"; that what was income before remained income and that the Government claims the right to tax "gains" in the "new dress" *only* when they were taxable "in their old dress" (*id.* p. 16).

This thought runs through the argument and appears in the final statement of the Government's brief as to the decision in the *Towne* case: " The Government failed because a stock dividend is a mere change of form and does not affect the taxability of that whose form it changes" (*id.* p. 35).

We have reviewed these emphatic statements of the Government's position, not only because they point very clearly the fallacies in the argument formerly urged by the Government in the endeavor to maintain that 'stock dividends' from their very nature constituted income, but also because they put in a strong light, as we view it, the lack of any valid basis for the tax assailed.

We answer

(1) The tax in question is not laid with respect to the taxpayer's interest in undivided corporate profits

as constituting income to the taxpayer, or upon the 'stock dividend' as the form or dress in which a previous gain or income to the taxpayer appears. The tax is laid upon the 'stock dividend' as constituting income in itself.

(2) Undivided corporate profits do not constitute income to the stockholder.

(3) 'Stock dividends' do not constitute income.

(4) The tax in question is an income tax and cannot be sustained as anything else. The 'stock dividend' is treated as a part of the taxable income and, as such, it is subjected to a graduated surtax according to the taxpayer's total net income from all sources.

FIRST. The tax in question is not laid with respect to the taxpayer's interest in undivided corporate profits as constituting income to the taxpayer, or upon the 'stock dividend' as the form or dress in which a previous gain or income to the taxpayer appears. The tax is laid upon the 'stock dividend' as constituting income in itself.

The Government's argument proceeds, as we think, upon a profound misconception of the statute. The tax on 'stock dividends' is a surtax. It is a graduated tax on the net income of individuals. The Act in question[1] (Section 2) provides that the "net income" shall include gains, profits, and income derived from salaries,

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[1]Act of September 8, 1916, Part I, Sec. 2 (a); 39 Stat. 756.

wages * *dividends'' etc. It provides that the term ''dividends'' shall include any ''distribution'' made by a corporation ''out of its earnings or profits accrued since March first, nineteen hundred and thirteen, whether in cash or in stock of the corporation ''*which stock dividend shall be considered income,* to the amount of its cash value.'' (Italics ours).

Thus, while the Act refers to a ''distribution'' out of corporate earnings accrued since March 1, 1913, it is the ''stock dividend'' that is to be ''considered income.'' Of course, Congress cannot make that income which concededly is not income, by saying that it shall be ''considered'' to be income. And if 'stock dividends' are not in themselves income, as it is apparent they are not, and as the Government is constrained to concede, 'stock dividends' in themselves cannot be ''considered income''.

The argument which the Government now advances in its endeavor to sustain the tax loses sight of a vital point. It goes without saying that the taxpayer can only be taxed upon *his* income. Congress by virtue of the power to lay taxes on income has no power to tax one man for the income of another. The argument for the Government by overlooking this fact involves a fundamental fallacy. The Act does not condition the liability of the taxpayer to pay the tax on 'stock dividends' by reference to any previous enjoyment by the taxpayer of any gain through the undivided earnings of the corporation which may have been capitalized.

He may not have any such gain at all. He may have bought the stock the day before the 'stock dividend' was declared. What he paid for the stock would be his capital investment. That investment covered the full value of the stock as he bought it and thus embraced the value of the assets of the corporation including all corporate surplus and undivided profits. The 'stock dividend,' as the Government says, "does not, of itself, make the stockholder richer than he was before." The Government admits that "what was not income before is not income after a stock dividend." Manifestly, then, the taxpayer has no income by virtue of the 'stock dividend' or by virtue of any corporate profits made before his purchase of the stock, as the interest in the surplus accumulated prior to his purchase is embraced in his capital investment on that purchase. The one who sells the stock to him, of course, is taxed on the profits realized by him through the sale. That is, the gain which the seller realized by the sale of the stock, including whatever enhancement of the value of the stock was due to undivided corporate profits made by the corporation before the sale, is taxed to the seller. The purchaser never had this gain, but still, when he (the purchaser) gets the 'stock dividend', although it is a "mere adjustment" of the evidence of his capital investment, he is compelled by the Act to pay the tax on the 'stock dividend' as "income". Not, as the Government concedes, because it is income, but as the Government contends because it is a "new dress" or garb or form of the interest in undivided corporate profits.

But this interest in undivided profits was no gain to the taxpayer whatever, but was embraced in the price paid for the stock and that gain is taxable to the seller of the stock, so far as he realized it through the sale, and is taxable to any preceding vendors to the extent that they realized a gain, through the increased value of the stock, on their respective sales.

In this particular case, the 'stock dividend' was declared on January 16, 1916. The capitalized surplus amounted to about $25,000,000. Of this upwards of $20,000,000 was surplus accumulated before March 1, 1913. About $4,500,000 was surplus earned by the corporation later and before January 1, 1916. It appears that Mrs. Macomber owned her stock before January 1, 1916, but the Act of 1916 did not tax her for that reason. It taxed her on the 'stock dividend' declared in 1916 because of that 'stock dividend' precisely and to the same extent as it would have taxed her on the same 'stock dividend' if she had bought her stock after January 1, 1916. *The Act taxed all those who got the added number of shares through the 'stock dividend' regardless of the question whether they had owned the stock when the capitalized profits were made by the corporation, that is, regardless of the question whether they previously had any gain whatever on the value of their holdings through the making of corporate profits during the period of their ownership.* The tax on 'stock dividends' as "income" hits every one who gets so-called 'stock dividends' although he may not in any way have had any increment of value whatever. He is, concededly, not enriched by the 'stock dividend' itself.

None of the capitalized profits may have been made while he was a stockholder. So far as his predecessors realized gains on selling the stock by reason of the accumulation of profits during their ownership, they have been taxed on that realized gain and when the stockholder in question sells he will of course be taxable on any gain he may realize through his sale.

It is therefore a fundamental misconception, which vitiates the argument of the Government, to say that the tax is laid on the gains accrued through the ownership of an interest in the undivided profits, which gain is simply taxed in its "new dress" or "changed form." This is to lose sight altogether of the actual tax and the situation of the taxpayer.

It is of the essence of an income tax that the taxpayer cannot escape. Income is essentially a thing personal to the taxpayer. It is, we think, a most extraordinary perversion to say that what is *not income to the taxpayer* can still be taxed as such, on the theory that there is a "change of form" in the income of *some one else* or a "new dress" for the income of some one else.

Congress has attempted to tax 'stock dividends' as income. The statute assumed in the Government's argument does not exist. No condition has been made that the taxpayer shall have had any previous gain through enhancement of the value of his investment by reason of the making of corporate profits. It makes no difference whether or not he has had any such gain, or

whether any enhancement that may have taken place is the gain of another who has sold the stock and thus actually realizing a gain is taxable thereon.

In view of the constant buying and selling of shares in a host of corporations, it is plain that for every taxpayer who has owned his shares of stock while undivided profits are being accumulated, there are other taxpayers who have not owned their shares during such period but who have paid the full value of the shares (based on all elements of value, corporate surplus included) and to whom the full value of their shares, as it stood before the declaration of the 'stock dividend,' was in no possible aspect anything but a capital investment.

The Government says that had Mrs. Macomber bought the 198 shares, which as a part of the 'stock dividend' it is sought to tax as income, that "they would clearly have *not* been income. She would merely have converted her cash capital into invested capital, and there would have been no gain" (Govt's Supp. Brief, p. 20). But the same would have been true had she bought her holding of 2200 shares in January, 1916, before the declaration of the 'stock dividend.' She would then have paid in the market the full value of the shares embracing all their proportionate interest in the aggregate corporate assets including the undivided surplus. When on the increase of stock through the 'stock dividend' she got 1100 additional shares she simply had in 3300 shares the same value that she had previously in 2200 shares, her proportionate interest being unchanged. This transaction, concedes the Government, would have "made her no

richer". That which "was not income before is not income after a stock dividend." Under this Act, however, she would have been taxed just the same.

The Act makes no distinction with respect to the time of acquisition. It does not attempt to tax on the condition that the taxpayer has had an increment of value through the undivided profits of the corporation that are capitalized, but it manifestly attempts to tax 'stock dividends' as such, as constituting income regardless of any such previous increment to the taxpayer's interest. No administration of this tax law could possibly be had under the law which would attempt any such distinction. It is the '*stock dividend*' which the Act says shall be *considered income*.

We refer below to the case of *Collector* v. *Hubbard*, 12 Wall. 1, but it may now be observed that under the Act of 1864, there under consideration, the tax was laid on the stockholder's interest in undivided corporate profits as an incident to his interest as a shareholder. But under that statute it was necessary to find as a fact, and the Trial Court in the *Hubbard* case (the case came up from the Supreme Court of Connecticut) did find as a fact, that "at the time of the assessment, which was made in the year 1865, and during the year 1864 which was covered by the assessment" the plaintiff owned the stock in the corporations on account of whose profits during the year 1864 he was taxed (*Hubbard* v. *Brainard*, 35 Conn. 563, 565). The *Hubbard* case affords no basis for the contention that the tax there in question could be laid, when

it was not based on the fact that the taxpayer owned the stock when the profits were accumulated and that the increment in value was added to the stock in his ownership. It gives no ground for the argument that a tax may be laid, as the present tax is laid, solely upon the fact that the taxpayer owns the stock at the time of the 'stock dividend,' that is, upon the mere receipt of the added shares constituting the 'stock dividend' without change in his proportionate interest. The two taxes are widely different. In the one case a person is taxed on the theory (which we consider *infra,* pp. 26 ff) that during the taxable period, by virtue of his ownership of the shares and by virtue of the undivided profits made by the corporation, the value of his stock interest has been increased. In the other, he is taxed because on a certain date he is the owner of a certain amount of capital, regardless of the question whether he has been enriched at all, and simply because of a readjustment in the evidence of his investment. The latter is certainly a direct tax upon property by virtue of ownership, unless the dividend in itself constitutes income which it is now conceded it does not. There was in the *Hubbard* case no taxation of 'stock dividends.' Whatever the bearing of that case upon the taxation of stockholders with respect to undivided corporate profits as constituting income to the stockholders, it has no application to this case, where the tax is not laid with respect to any such increment to the taxpayer.

We repeat:—In the vast number of cases where the shares have been sold after the accumulation of profits

which are subsequently capitalized on the issue of the stock dividend, the tax in question against the buyer whose capital investment represented the full value of the shares (based on all elements of value including the undivided profits) cannot be sustained on the theory that the 'stock dividend' which the buyer receives is income to him because of any gain to him through the accumulation of profits during the ownership of another. When the added shares constituting the 'stock dividend' are issued, he has the same capital investment,—the same proportionate interest of the same value. The tax in question is obviously nothing but a tax on his capital investment. *The statute authorizes no distinction between such purchasers and any other stockholders who get 'stock dividends.' All who get 'stock dividends' are on the same footing under the law. As to all there is the same criterion of taxability. It is the "stock dividend" that is to be "considered income."* The statute treats the mere declaration of the 'stock dividend' and the receipt of the new certificates as constituting income, as if this transaction had made the taxpayer richer than before when, in fact, as the Government admits, it had not.

The entire structure of the Government's argument thus rests, as we view it, on an unsound foundation.

SECOND. Undivided corporate profits are not income to the stockholder.

It is of the essence of income that it should be realized. Potentiality is not enough. Book entries or opinions of increase are not income. Income necessarily

implies separation and realization. The increase of the forest is not income until it is cut. The increase in the value of lands due to the growth and prosperity of the community is not income until it is realized. Where investments are concerned, there is no income until there has been a separate, realized gain. When a corporation earns profits, it receives money over the amount of its expenditures. The money belongs to the corporation; the profits are the property of the corporation. If the corporation distributes its earnings in dividends, properly so-called, that is, in money, or in property *in specie*, the stockholder has realized a gain and that gain is income. The amount was the corporation's; it is now his, separated and realized. If the corporation, instead of segregating a portion of its property and transferring the ownership to the stockholders, accumulates its net earnings and invests them in plant and betterments, what gain has the stockholder? Apart from the dividends actually paid and segregated from the corporate assets he has realized nothing. His shares may have increased in value, but he has not realized the increase. He cannot realize it except by selling his shares, or some of them, or through a liquidation. If he sells the shares and in this way realizes a gain from his investment, this gain is income and he is taxable on it. Let it also be assumed for the argument's sake that if the corporation is liquidated, and the assets are distributed or are converted into money and the money distributed among the stockholders, he then realizes his share and whatever gain he thus realizes on his investment is income and he is taxable on it.

But unless he realizes a gain by selling his shares, or through liquidation, what has he by reason of the use by the corporation of its accumulated earnings in extensions of plant? He may have an enhanced value of his shares, but this is simply the enhanced value of his proportionate interest, his capital investment. It is not yet income. So far as he is concerned, it is potential but not realized. His interest is still the capital interest of a stockholder.

The enhancement in the value of his shares may never be realized. It is still involved in the enterprise. It may decrease in value. When the stockholder does sell, he may get no gain whatever. When the corporation liquidates, he may have no gain. The unrealized increment is not income and may never become income.

The Government speaks of dividends as "forms" of corporate profits (Govt's. Supp Brief, p. 13). But true dividends are not "forms". They are the realized gains to the stockholder, realized by the transfer of property into his ownership. He no longer has merely a capital interest, that is, his right to receive dividends, his right to a proportionate share of the net assets on liquidation, he not only has a capital interest, but he has separated from that and transferred into his separate ownership a sum of money which is his separate property, segregated from his share investment. Because a 'stock dividend' is not a dividend at all, but only a readjustment of the evidence of an interest already owned, it does not follow that true dividends in cash or property are "forms". This characterization cannot avail

to obscure the distinction between what is a true dividend and what is not.

The enhanced value of shares through investment of corporate surplus still leaves the stockholder without income. The fact that he may sell and thus realize is not the same as realization. The value, whatever it may be prior to sale or liquidation, is still the value of his capital interest. There is no income while the investment is in this conditon, except as true dividends are received by which sums of money or specific assets are separated from the capital investment and realized as gains to the stockholder.

There should be no confusion of mere accretions to capital and income. When a tax is laid on property according to value, of course, the property interest is valued with all its accretions. Thus, if a tax is laid on the property of A, which consists of shares of stock, these shares should be valued at whatever they may be worth acording to the available standards of value. In thus valuing shares. the entire proportionate interest in the aggregate assets of the corporation would be valued without distinction between capital and surplus. But the fact that this property in shares may be valued at a given amount, and that this value may include the proportionate interest in undivided profits cannot be taken to import that the interest in undivided profits is income. The enhanced value of the shares is merely the enhanced value of the capital investment. The accretion has not been separated from the capital. When a property tax is laid, that entire value may be taxed as the value of the property. But the unseparated and un-

realized increment of capital cannot be treated as income and taxed as such. For example, if the Federal Government laid a direct tax by apportionment on the shares as property, the value of the shares would be taken on the basis of their proportionate interest in all the corporate assets, undivided profits of the corporation as well as capital. But in laying an income tax under the Sixteenth Amendment, it must appear that there has been income, that is, a separated, realized gain and it is not enough to point to an unseparated accretion to the capital investment, which as a part of that capital interest would appropriately be valued if a direct tax were laid upon it.

It is evident that the interest of a shareholder, by virtue of the ownership of his shares, is a *capital* interest. It is a single interest in the aggregate assets of the corporation subject to the payment of debts. The shareholders are not the owners of the property, profits or the invested accumulations of the corporation. The interest of each shareholder in the assets of the corporation is one that can only be enjoyed in possession in case there is a winding-up or liquidation. The fact that the value of the share interest may be greater at one time than another in no way changes the nature of the interest. The shareholder has the right to vote, to receive dividends, and on liquidation to receive his proportionate part of the surplus that may remain after debts are paid. He has the right to have the assets of the corporation properly employed in the corporate enterprise. He may transfer his right by sale. Except as he receives dividends he has no segregated interest in corporate surplus or

undivided profits. His interest by virtue of stock ownership is always his proportionate right with respect to the aggregate assets of the corporation, subject to the payment of all liabilities, and he has no divisible interest in the profits which the corporation holds, without distribution, and invests in its plant and business. The shareholder has simply his share, his interest, in the corporate enterprise. The corporation must, of course, pay its income tax upon its profits, but there is no income to the shareholder unless he receives it. His share interest is a "capital" interest.

At this point, it may be observed that the profits earned by the corporation are its property, not the property of the shareholders. This distinction is not a form or technicality. It is a vital distinction inherent in corporate organization. The interest of the shareholder is a distinct interest. The profits of the corporation are not his profits. This distinction between the title of a corporation and the interest of its shareholders in the property of the corporation, including its earnings, has been authoritively established by two lines of decisions of this Court in cases involving the power of taxation.

In the first the Court considered the power of the states to tax shares of stock of national banks in the hands of shareholders, and it was held that although all of the capital of the national bank was invested in securities of the United States, which were tax exempt, the states were authorized, under the consent given by Congress, to tax national bank shares because of the substantial distinction between the interest of the shareholders and that of the corporation. In the leading case, *Van Allen* v. *The Assessors*, 3 Wall. 573, the Court said (p. 584):

"The tax on the shares is not a tax on the capital of the bank. The corporation is the legal owner of all the property of the bank, real and personal and within the powers conferred upon it by the charter, and for the purposes for which it was created, can deal with the corporate property as absolutely as a private individual can deal with his own * * *

"The interest of the shareholder entitles him to participate in the net profits earned by the bank in the employment of its capital, during the existence of its charter, in proportion to the number of his shares; and, upon its dissolution or termination, to his proportion of the property that may remain of the corporation after the payment of its debts. This is a distinct independent interest or property, held by the shareholder like any other property that may belong to him."

The same ruling was made in

People v. *Commissioners,* 4 Wall. 244;

Bradley v. *The People,* 4 Wall. 459;

National Bank v. *Commonwealth,* 9 Wall. 353, 358, 359;

Owensboro National Bank v. *Owensboro,* 173 U. S. 664, 680.

See also,

Evansville Bank v. *Britton,* 105 U. S. 322;

Cleveland Trust Company, v. *Lander,* 184 U. S. 111;

Home Savings Bank v. *Des Moines,* 205 U. S. 503;

Rogers v. *Hennepin County,* 240 U. S. 184.

The second line of authorities consists of decisions in controversies involving the impairment of contracts for tax exemption, in which again this Court has pointed out that the taxation of a shareholder on account of his interest in the property of the corporation is not the equivalent of a tax on the corporation's property.

Bank of Commerce v. *Tennessee,* 161 U. S. 134, 146;
Shelby County v. *Union and Planters' Bank,* 161 U. S. 149, 153-154;
Wright v. *Georgia R. R. & Banking Co.,* 216 U. S. 420, 425.

See also,

Farrington v. *Tennessee,* 95 U. S. 679;
Sturges v. *Carter,* 114 U. S. 511;
Tennessee v. *Whitworth,* 117 U. S. 129;
New Orleans v. *Houston,* 119 U. S. 265;
New Orleans v. *Citizens' Bank,* 167 U. S. 371;
Powers v. *Detroit & Grand Haven Ry.,* 201 U. S. 543.

When the question of the nature of the shareholder's interest in undivided profits came before this Court in *Gibbons* v. *Mahon* (136 U. S. 549) the question was carefully considered and explicitly determined. The Court pointed out the distinction between the money earned by the corporation, and the shareholder's income, and ruled expressly that the interest of the shareholder in the accumulated earnings of the corporation, as a part of his share interest, was capital and not income, so long as the earnings were held and

invested by the corporation as a part of its corporate property.

It is apparent that in *Gibbons* v. *Mahon, supra,* the former expressions in opinions of this Court had been carefully examined (136 U. S. p. 560). It was remarked that the opinion of Mr. Justice Clifford in the *Bailey* case, 22 Wall. 604, contained "some general expressions which, taken by themselves, might seem to ignore the settled distinction, (affirmed by this court in earlier and later cases above cited,) between the property of the corporation and the interests of the shareholders." Summarizing its views, the Court said in the *Gibbons* case, speaking through Mr. Justice Gray (*id.* pp. 557, 558):

> **"The distinction between the title of a corporation, and the interest of its members or stockholders, in the property of the corporation, is familiar and well settled. The ownership of that property is in the corporation, and not in the holders of shares of its stock. The interest of each stockholder consists in the right to a proportionate part of the profits whenever dividends are declared by the corporation, during its existence under its charter, and to a like proportion of the property remaining, upon the termination or dissolution of the corporation, after payment of its debts. Van Allen v. Assessors, 3 Wall. 573, 584; Delaware Railroad Tax, 18 Wall. 206, 230; Tennessee v. Whitworth, 117 U. S. 129, 136; New Orleans v. Houston, 119 U. S. 265, 277.**
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> **"Money earned by a corporation remains the property of the corporation, and does not become the property of the stockholders, unless and until it is**

> **distributed among them by the corporation. The corporation may treat it and deal with it either as profits of its business, or as an addition to its capital. Acting in good faith and for the best interests of all concerned, the corporation may distribute its earnings at once to the stockholders as income; or it may reserve part of the earnings of a prosperous year to make up for a possible lack of profits in future years; or it may retain portions of its earnings and allow them to accumulate, and then invest them in its own works and plant, so as to secure and increase the permanent value of its property. * * ***
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> **"Reserved and accumulated earnings, so long as they are held and invested by the corporation, being part of its corporate property, it follows that the interest therein, represented by each share, is capital, and not income, of that share, as between the tenant for life and the remainderman, legal or equitable, thereof."**

And, in the opinion in *Towne* v. *Eisner, supra,* referring to the 'stock dividend' there under consideration and to the views expressed in *Gibbons* v. *Mahon* this Court said;

> **"Notwithstanding the thoughtful discussion that the case received below we cannot doubt that the dividend was capital as well for the purposes of the Income Tax Law as for distribution between tenant for life and remainderman. What was said by this court upon the latter question is equally true for the former."**

It is thus to be observed that the Court in the *Gibbons* case not only held that the 'stock dividend' was not income, but also distinctly ruled that the interest of the

shareholder in the accumulated earnings of the corporation, so long as they are held and invested by the corporation, is a *capital interest* and *not* income.

It is in the light of the clear authorities which we have cited that the case of *Collector* v. *Hubbard*, 12 Wall. 1, upon which it is apparent that the Government chiefly relies, should be considered.

The *Hubbard* case arose under section 117 of the Act of 1864 (13 Stat. 281, 282), which provided that "the gains and profits of all companies," other than those otherwise taxed, should "be included in estimating the annual gains, profits or income of any person entitled to the same, whether divided or otherwise."

It is manifest that the provision of the Act of 1864, was to insure the payment of the tax upon the earnings of the corporation (see *Gibbons* v. *Mahon*, 136 U. S. 549, 560). Under the Act of 1864 there were three provisions relating to taxes upon corporate earnings. Section 122 (13 Stat. 284-285) related to railroad, canal and turnpike companies and provided for a tax of five per cent upon the amount of interest, dividends or profits. After a long-standing difference of opinion [1] it was finally de-

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[1] *Barnes* v. *The Railroads*, 17 Wall. 294, 309, 319; *United States* v. *B. & O. R. R. Co.*, 17 Wall. 322; *Stockdale* v. *Insurance Companies*, 20 Wall. 323, 329. 337; *Bailey* v. *Railroad Co.*, 22 Wall. 604; *Railroad Company* v. *Collector*, 100 U. S. 595; *Bailey* v. *Railroad Co.*, 106 U. S. 109; *United States* v. *Erie Railway Co.*, 106 U. S. 327, 329, 330, 331; *Memphis & Charleston R. R. Co.* v. *United States*, 108 U. S. 228, 234. See *United States* v. *Louisville & N. R. R. Co.*, 33 Fed. 829, 831, 832; *Pollock* v. *Farmers Loan & Trust Company*, 157 U. S. p. 578.

cided that this was essentially an excise tax on the business of the described corporations (*Railroad Company* v. *Collector*, 100 U. S. 595, 598; *United States* v. *Erie Railway Co.*, 106 U. S. 327, 330). By section 120 of the same Act (13 Stat. 283, 284) provision was made for a similar tax with respect to the earnings of banks, trust companies and insurance companies.

Section 117, which was before the Court in the *Hubbard* case, related to the earnings of all other companies that is, all companies except those above specified, and embraced the manufacturing corporations, the earnings of which were there in question. Section 117 was thus intended to reach corporate earnings not otherwise taxed. As the Attorney General said in his argument (12 Wall. p. 8), after referring to the different methods employed in these sections of the Act of 1864: "In all cases the entire annual gains and profits of every corporation, divided or undivided, seem to be within the aim and purview of the statute as objects of taxation."

There was no attempt to tax both the corporation and the shareholder with respect to the same earnings. The statute under consideration in the *Hubbard* case was plainly a crude method of reaching the corporate earnings and was the only tax imposed with respect to those earnings.

And there can be no doubt as to what was taxed in that case. Hubbard was taxed upon an undivided interest in corporate profits which had been retained by the corporation and invested in the corporate enterprise

or appropriated to the payment of the corporate debts. The fact that the statute directed that the gains and profits of the corporation, although undivided, should be included in estimating the annual gains, profits or income of the shareholder, clearly indicates that the shareholder, during the taxable period and while he was a shareholder, was to be taxed upon the increment supposed to have been added to the value of his share by his proportionate interest in the undivided profits. This, as a matter of statutory construction, is clear enough. But it by no means follows that this increment was income to the shareholder, when it becomes necessary to distinguish between a tax on income and a direct tax on the capital investment including all that is still a part of the capital investment and does not represent any gain separated therefrom and realized by the shareholder.

The fact that the tax is on the supposed increment, by reason of the proportionate interest of the shareholder, through ownership of his shares, in the undivided profits of the corporation, is one thing; the nature of the increment is quite another.

We are not left in doubt as to the nature of that increment. It has been explicitly described in the opinion of this Court in *Gibbons* v. *Mahon* (*supra*). To repeat, the Court there, fully conscious that there were ambiguities expressed in the statements in earlier opinions, set the matters at rest by saying in so many words:

> "Reserved and accumulated earnings, so long as they are held and invested by the corporation, being part of its corporate property, it follows

> that the interest therein, represented by each share is *capital, and not income,* of that share, as between the tenant for life and the remainderman, legal or equitable, thereof." (Italics ours.)

It is manifest that the interest in the undivided profits as between the tenant for life and remainderman, was a capital interest and not income simply because that was the truth of the matter. That is, because it was not income in fact or law. Plainly, that which is not income does not become income by having a tax put upon it.

The reasoning of Mr. Justice Gray in delivering the opinion of the Court in the *Gibbons* case is unassailable.

When the Court is asked to conclude that a tax on the increment through the shareholder's interest in undivided profits, was a tax on *"income,"* the Court is asked to repudiate its explicit declaration to the contrary in the *Gibbons* case.

This repudiation is not required by anything said in the *Hubbard* case. For the *Hubbard* case was dealing with the mere fact of the increment and did not deal with its nature, as the Court in the *Gibbons* case was called upon to deal.

The reason why the Court in the *Hubbard* case was not called upon to define the nature of the increment, beyond the fact that it was *property,* is apparent from the absence of any controversy over a constitutional question, and from the opinion entertained at the time with respect to what was a direct and what was an indirect tax under the Federal Constitution.

It was sufficient in the *Hubbard* case to determine that there was an increment, although unrealized. If there was an increment through the proportionate share in undivided profits of the corporation, the statute was satisfied, and the validity of the statute was not assailed. Moreover, had its validity been assailed, it would have been thought sufficient at that time to say that the tax was on personal property and whatever the nature of the increment, it being a tax upon that increment as an incident to a share which was personal property, it was not a direct tax. Hence, in the view then entertained, before the *Pollock* case, * the tax could be sustained, as it was quite generally supposed that direct taxes were taxes on real estate and capitation taxes.

Under the understanding at that time of direct and indirect taxes the decision was unassailable. From the beginning until the decision of the *Pollock* case it was generally understood that direct taxes in the constitutional sense embraced only capitation taxes and taxes on land, and that a tax on personal property was in the class of indirect taxes. In the first case which came before this Court involving the meaning of direct taxes (the *Hylton* case†) it was held that a tax on personal property was not a direct tax, and the opinions of the Court, some of whose members had participated in the proceedings of the Constitutional Convention, clearly expressed their

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*158 U. S. 601

†3 Dall. 171

view that direct taxes included only capitation taxes and taxes on land. These expressions, repeated in subsequent decisions of this Court, were in harmony with the views of eminent commentators on the Constitution and were generally accepted as a definition of direct taxes.

> *Veazie Bank* v. *Fenno,* 8 Wall. 533;
> *Pacific Ins. Co.* v. *Soule,* 7 Wall. 433;
> *Scholey* v. *Rew,* 23 Wall. 331;
> *Springer* v. *U. S.,* 102 U. S. 586;
> 1 *Kent's Commentaries,* 254-256;
> 1 *Story on the Constitution,* Sec. 955.

Indeed in 1861 when it was proposed to levy a direct tax, by apportionment, on personal property, a committee of the House of Representatives reported that under the *Hylton case it could not be done* (see 158 U. S. p. 710). So, in 1870, when the *Hubbard* case was decided it was sufficient to sustain the tax that the subject of the tax was personal property.

That we are not misconstruing the *Hubbard* case is apparent from the opinion there delivered by Mr. Justice Clifford. He said:

> "Decided cases are referred to, in which it is held that a stockholder has no title for certain purposes to the earnings, net or otherwise, of a railroad prior to the dividend being declared, and it cannot be doubted that those decisions are correct as applied to the respective subject-matters involved in the controversies. Grant all that, still it is true that the owner

of a share of stock in a corporation holds the share with all its incidents, and that among those incidents is the right to receive all future dividends, that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a member of the corporation until a dividend is made. Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift or devise. Undivided profits invested in real estate, machinery, or raw material for the purpose of being manufactured are investments in which the stockholders are interested, and when such profits are actually appropriated to the payment of the debts of the corporation they serve to increase the market value of the shares, whether held by the original subscribers or by assignees. But the decisive answer to the proposition is that Congress possesses the power to lay and collect taxes, duties, imposts, and excises, and it is as competent for Congress to tax annual gains and profits before they are divided among the holders of the stock as afterwards and it is clear that Congress did direct that all such gains and profits, whether *divided or otherwise,* should be included in estimating the annual gains, profits, or income liable to taxation under the provisions of that act. Annual gains and profits, whether divided or not, are property, and, therefore, are taxable."

Of course, Mr. Justice Clifford found that there was an increment. But his point was that this increment was "an incident to the shares". He says that "re-

garded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift or devise." This is true of all capital interests.

And in conclusion the learned Justice says that the annual gains or profits "are property, and, therefore, are taxable."

It was not necessary for Mr. Justice Clifford, in the absence of the debate which about twenty-five years later took place in the *Pollock* case, to go further. When however the Court had occasion to deal with the precise question, in *Gibbons* v. *Mahon*, the Court stated its conclusion emphatically, and without the slighest reservation, that *whatever increment there was, through undivided profits held and invested by the corporation, to the share of the stockholder, was capital and not income.* The Sixteenth Amendment, as stated in the *Brushaber* case, * must be regarded as accepting the *Pollock* case and as virtually making that decision part of the Constitution, except so far as the Sixteenth Amendment itself has modified it.

The increment in the *Hubbard* case was nothing but an accretion to capital. It was not a separated, realized gain. It was not income. Hence, under the doctrine of the *Pollock* case and the doctrine now applicable to all cases where a capital interest is taxed, the tax could not validly be laid except as an apportioned direct tax. Take

*240 U. S. 1.

the case of estates where investments in stocks have come into the possession of trustees, would any one have the hardihood to maintain that a tax upon the undivided profits of the corporations was a tax which could validly be laid upon the income of the tenant for life, and that the tenant for life, not receiving any separated or realized gain, could have what he did receive diminished for the purpose of paying such a tax? Suppose in the *Hubbard* case, under the Act of 1864, instead of Hubbard there had been the trustees of Hubbard's estate owning the stock during the period when the undivided profits were made by the corporations and Hubbard's wife had been the tenant for life and entitled to the income, would the tax have been sustained as a tax upon the income? The same discussion which was had later in the *Gibbons* case must inevitably have taken place and we must assume in the light of the *Gibbons* decision that the law would have been declared to be that the increment through the proportionate interest of the shareholder in the undivided profits of the corporation was a capital interest and not income.

We see no reason why the Court should be asked to repudiate the clearly expressed doctrine of the *Gibbons* case in order to give effect to a ruling which is not found in the *Hubbard* case and which if there found would be opposed to sound reasoning and to the Court's later decision.

We do not find that the *Hubbard* case has been followed, in the sense that the Government implies. The Government cites *Bailey* v. *The Railroad,* 22 Wall. 604,

635, 636. We have already referred to the decision in the *Bailey* case (ante, p. 23) and it is that case, and precisely the portion of the opinion to which the Government alludes, that is discussed and limited by the opinion of this Court in the *Gibbons* case (136 U. S., pp. 557-558). Mr. Justice Gray there said, as already noted, that the opinion in the *Bailey* case, which was written by Mr. Justice Clifford, (who also wrote the opinion in the *Hubbard* case) contained "some general expressions" it was necessary to limit and there can be no doubt that the decisions prior to the *Gibbons* case received most careful attention.

As a pronouncement in support of a tax on 'stock dividends' as "income" the *Bailey* case was deprived of any standing or authority by the decision in the *Gibbons* case, and the latter decision expressly holds, as we have seen, that the proportionate interest of a shareholder in the undivided profits of a corporation is capital and not income. Thus, in the light of the *Gibbons* case, there is nothing in the *Bailey* case which can be deemed to be a sanction of what the Government now seeks to deduce from it for the purposes of the present case.

Since the *Gibbons* case, the *Hubbard* case has not been cited, we believe, except in *Southern Pacific* v. *Lowe*, 247 U. S., 330, 336; *Lynch* v. *Turrish*, 247 U. S., 221, 228; and *Lynch* v. *Hornby*, 247 U. S., 339, 343. As these recent cases were decided by this Court as now constituted, the Court needs no suggestion as to the import of the citations. We may say, however, that we do

not find anything in the citations to support the Government's contention. In *Southern Pacific* v. *Lowe,* it was cited merely to be distinguished and it was pointed out that the decision was based on the very special language of the Act of 1864. The point now under consideration was not discussed.

In *Lynch* v. *Turrish, supra,* it was said that in the *Hubbard* case "the distinction between a corporation and its stockholders was recognized and that the stockholder had no title for certain purposes to the earnings of the corporation, net or other, prior to a dividend being declared, but they might become capital by investment in permanent improvements and thereby increase the market value of the shares, 'whether held by the original subscribers or by assignees'. In other words, it was held that the investments of the corporation were the investments of the stockholders; that is, its stockholders could have an interest, taxable under the act considered, though not identical with the corporation." But we do not find in this statement anything inconsistent with what was explicitly ruled by this Court in the *Gibbons* case, that the interest of the shareholder in profits invested by the corporation was essentially a capital interest. The question now being discussed was not involved in any way in the *Turrish* case. Nor does the case of *Lynch* v. *Hornby, supra,* involve the present question.

To conclude, the shareholder who does not realize a gain through the sale of his shares or through the liquidation of the corporation, obtains no separated, rea-

lized gain from any increment in value through the enhancement of the value of his shares by reason of earnings of the corporation which are invested and not divided among the shareholders. Before he realizes that gain the shareholder has nothing apart from his capital investment, represented by his shares,—his proportionate interest in the aggregate assets of the corporation. It may be there is an increment to that capital interest in the sense that its value is enhanced, but that value means nothing separately realized by the stockholder. The economic distinction is established beyond controversy. Such an enhancement in the value of a capital interest, through undivided profits, is not income, either in economics or in law. It is not income in law, because it is not income in fact. It is not income in law because it has been judicially determined by this Court not to be income, but to be capital.

THIRD. 'Stock Dividends' do not constitute income. Income is the gain, come to fruition, from capital, from labor, or from both combined. This is sound doctrine both in law and in economics. *a.* **Income of a corporation is not income of a shareholder until distributed.** *b.* **A 'stock dividend' is not income. It does not constitute a distribution of anything; it is a mere readjustment of capital.**

"Income" has been repeatedly defined by this Court. In *Stratton's Independence* v. *Howbert* 231 U. S. 399, at page 415, the Court said:

> " 'Income' may be defined as the gain derived from capital, from labor, or from both combined."

This definition was reaffirmed in *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 185, where it is said that

> "Whatever difficulty there may be about a precise and scientific definition of 'income', it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities. As was said in *Stratton's Independence* v. *Howbert*, 231 U. S. 339, 415: 'Income may be defined as the gain derived from capital, from labor, or from both combined.' "

The "gain" referred to in this definition must exist not only in the sense of "increase"; it most be separated, be realized. Gain as mere unseparated accretion is not income. The gradual increase in value of a parcel of real estate, the appreciation in value of a diamond, may be said to constitute gain in the sense that the real estate or the diamond is at the later time worth more to the owner than at the earlier time, but in no sense does the gain constitute income; it is simply increment of capital. It is essential to "income" that the gain be separated, that it be realized, that it come to fruit. This Court in *Lynch* v. *Hornby*, 247 U. S. 399, at page 343, said that accumulations of corporate profits would be taxable to the stockholder

> "only if and when and to the extent that his interest in them comes to fruition as income, that is, in dividends declared."

Again, in *Lynch* v. *Turrish,* 247 U. S. 221, at page 231, the Court said:

> "Advance in value is not income at all but merely increase of capital and not subject to a tax as income."

And earlier, it had been held that

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital." *Gray* v. *Darlington,* 15 Wallace, 63 at page 66.*

In a recent English decision (July 19, 1919) it was held by the Court of Appeal that there was no liability for a surtax on so-called " bonus shares". Mr. Justice Rowlatt, in delivering the opinion of the Court said:

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*Under the British Income Tax Act (16 & 17 Vict. c. 34) it is established that appreciations in value of capital assets, even after the realization of profits by sale, do not constitute taxable income except in cases of transactions by dealers or other persons who buy and sell for purposes of profit. *Tebrau (Johore) Rubber Syndicate, Limited,* v. *Farmer,* S. T., 5 Income Tax Cases, 658; *Stevens* v. *The Hudson's Bay Company,* 5 Income Tax Cases, 424; *The Assets Company, Ltd.,* v. *The Inland Revenue,* Cases in the Court of Session, 4th Series Vol. 24, p. 578.

"I do not think that there is a payment of a dividend to a shareholder unless a part of the profits of the company is thereby liberated to him in the sense that the company parts with it and he takes it. If, in this case, the company could have found means to capitalize its profits and divide them as capital without adopting the machinery of declaring a bonus and allotting shares by agreement (not a voluntary agreement) in satisfaction of such bonus, I do not think the case would have been arguable."

Commissioners of Inland Revenue v. *John Blott,* reported in the "London Times" of July 25, 1919.

These legal definitions of income are firmly supported by the views of leading economists:

"Income and capital are therefore two aspects of wealth. In the one case we measure wealth as a *flow* of services or a *stream* of satisfactions; in the other case as a *stock* of services or a *fund* of satisfactions." E. R. A. Seligman, Principles of Economics, 7th Ed., page 16.

"Income as contrasted with capital denotes that amount of wealth which flows in during a definite period and which is at the disposal of the owner for purposes of consumption, so that in consuming it his capital remains unimpaired." Seligman, Income Tax, page 19.

The nature of a 'stock dividend', economically considered, is well set forth in an article, "The Economic Nature of the Stock Dividend", by Professor Fairchild, in The Bulletin of the National Tax Association, Vol. III, No. 7, April, 1918, at page 163:

"The inclination to regard a stock dividend as income may sometimes be traced back to the notion that an increase in the value of capital is income. This fundamental error has been the cause of much confusion. Let us see exactly what is the relation between capital and income. Capital is a fund or stock of wealth in existence at a given time. Income is the flow of services or benefits of capital during a period of time. The balance sheet, as of a certain date, shows capital; income appears in the income account of a certain year or other period. Capital yields income when it performs some service for its owner. Mere growth in amount of capital is not income. The owner is becoming richer, but he is receiving no income from this capital. The income is being deferred to the future. In fact, it is by this very postponement of income that the capital is allowed to increase in value. A forest plantation increases in value as the trees grow up toward marketable age. But this growth is not income. If, before any timber had been cut, a fire should destroy the forest we could not say that the owner had enjoyed any income from this piece of capital. He would have been just as well off if there had been no growth."

The economic considerations with respect to the nature of 'stock dividends' are ably discussed by Professor Edwin R. A. Seligman in "Are Stock Dividends Income" (American Economic Review, Vol. IX, No. 3, p. 517). With the Court's permission we shall submit a copy of the article with this brief.

It clearly appears, therefore, that "income" has these invariable characteristics:

(*a*) It must be gain;

(*b*) The gain must be separated from the capital, realized by the recipient;

(*c*) The capital must remain intact after the separation.

Increase in value of a capital asset is mere accretion or accumulation of capital—it can become income only by separation, by realization; for instance, where the property, whether real estate, chattels, securities or what not, is sold, the gain is separated, is realized, is in hand,—in short, is income; so also, accumulations of earnings or profits of a corporation are, until distributed, in nature precisely like the accretion to the value of a chattel; in order to become income they must be separated. For instance, in the case of corporate earnings, they must no longer be under the control of the corporation—they must, on the contrary, be in the sole dominion of the stockholder. This can come about only by distribution,—whether the distribution be called dividend or not and whether it be in money or *in specie*. Ordinarily, the distribution, so far as the stockholder is concerned, is in cash, which is in the absolute control of the stockholder, separated therefore from the corporation, the capital remaining unimpaired. But the distribution need not be in cash so long as there is complete separation. When, as in *Peabody* v. *Eisner*, 247 U. S. 347, the Union Pacific Rail-

road Company distributed stock of the B. & O. R. R. Co., the Union Pacific stockholder received something separated from the Union Pacific corporation, in his own absolute dominion, and besides he lost nothing of his previous proportionate interest and right in the Union Pacific Company itself.

This Court in *Towne* v. *Eisner* expresses the true doctrine when it says that

> "If the sum [that is some definite amount of the surplus account representing accumulated profits] had been carried from surplus to capital account without corresponding issue of stock certificates, which there was nothing in the nature of things to prevent, we do not suppose that any one would contend that the plaintiff had received an accession to his income." *Towne* v. *Eisner,* 245 U. S. 418, p. 426.

Unseparated increment, whether in the value of the property or in the amount of accumulated earnings, is capital; separated and distributed accretion of the one sort or the other is income; it becomes income in the act of separation and distribution, not otherwise.

This is not to indicate that a shareholder's gain through accretion to capital through the earning of corporate profits will not ultimately pay income tax. The tax will be imposed instantly the gain is realized. and that will occur immediately upon sale—and then whatever profit is realized becomes income and is taxable accordingly.

There is a constant assumption on the part of the Government that a 'stock dividend' "represents" only

the surplus earnings of the corporation and that a declaration of a 'stock dividend' constitutes a separation and distribution of those earnings. Both assumptions are erroneous. 'A stock dividend' does not represent the surplus. It is occasioned by the surplus—it would not come into being unless there were a surplus; but it represents its due proportion of the total assets,—that is, its due proportion of the original capital as well as of the surplus. To illustrate: A corporation of $100,000 capital accumulates surplus earnings of $50,000; it declares a 'stock dividend' of fifty per cent.; the new shares, precisely as the old shares—no more, no less, represent a due proportion of the sum of the capital and the surplus.

It is fundamental that a 'stock dividend' distributes nothing; it is a mere readjustment of capital. It cannot be said that there is a distribution unless there be a distributor and a distributee; that something be given and something received—necessarily something that the distributee had not already. The whole thing is a mere bookkeeping expedient. Let us illustrate: A corporation starts with capital of $100,000, and assets $100,000. Its books would show

Liabilities.		Assets.	
Capital	$100,000	Miscellaneous Items	$100,000

Later the corporation makes a profit of $50,000. These profits are crystallized in additional assets and on the books an equivalent amount will appear as a liability. The books will then show the following:

Liabilities.		Assets.	
Capital	$100,000	Miscellaneous Items	$150,000
Surplus or undivided profits	50,000		
	$150,000		

Obviously the stock of this corporation has a book or intrinsic value of one hundred and fifty per cent.—that is $150,000. The company determines that it will not distribute the surplus earnings, but on the contrary will so adjust its affairs that they cannot hereafter be distributed as dividends but must hereafter be retained as capital. To this end the corporation issues a 'stock dividend' of fifty per cent. As a consequence the corporation has now a capital of $150,000 and no surplus earnings. This is expressed upon the books as follows:

Liabilities.		Assets.	
Capital	$150,000	Miscellaneous Items	$150,000

It must be clear as noon-day that here, after the issuance of the 'stock dividend', the total stock, old and new, taken together, is worth and represents precisely the same as the original stock before the issuance of the 'stock dividend'.

The only thing that has happened is that upon the balance sheet of the corporation the item which there stood as "Undivided profits" has disappeared and its amount has been added to the item "Capital". Both, however, are under the general head "Liabilities" and both are balanced by precisely the same assets of pre-

cisely the same value. That this constitutes a distribution to the stockholder of anything not theretofore his own is an absurdity. On the contrary, the corporation has determined not to distribute its earnings but to invest them in plant and improvements. This it cannot safely do on any considerable scale save from its capital. It therefore impounds the surplus, uses it as capital and issues the new certificate as evidence that the former surplus is no longer distributable but permanently invested as capital.

It appears, therefore,

(a) That until separated from the corporation, distributed to the stockholder, corporate earnings are mere accretion of capital;

(b) That a 'stock dividend' is not income because it does not constitute a distribution of anything:

(c) That a 'stock dividend' is a mere readjustment of capital.

'Stock dividends' are not income within the meaning of the Sixteenth Amendment.

We have shown, as we think, in the preceding point, that economically considered a 'stock dividend' is not income, but in view of the statements contained in some of the opinions of other courts, which the Government cites, we shall here briefly review some of the further

considerations which, as we view it, lead to the conclusion that 'stock dividends' are not income. If they are not income in the sense that they make the shareholder richer than he was before it can hardly be contended that they should be regarded as income within the meaning of the constitutional provision.

The situation here presented is a typical one and the facts to which the question is addressed are familiar.

A corporation is not bound to distribute all its earnings in dividends. The directors may properly decide to use a portion of the earnings for the development of business, for the extension of plant, for betterments and for working capital. The undivided surplus of a corporation is not, normally, idle money; it is, normally, invested money. It is money invested in property, or embarked in the corporate enterprise; that is the reason it is not paid out in dividends. If the directors have not transcended the broad limits of their judgment, the shareholders cannot complain because earnings are invested instead of being distributed.

The interest of the shareholders, with respect to the property of the corporation, is not an interest in the segregated portion representing the original subscriptions; it is not an interest limited to an amount equal to the par value of their shares; it is not an interest limited to any particular portion of the corporate property, in the absence of special charter provisions, but is simply an interest in all the corporate assets. When these assets are swelled by the addition of undivided profits,

the interest of the shareholders in these accumulations is precisely the same as their interest in any other property of the corporation. "The property of every company may consist of three separate distinct things, which are its capital stock, its surplus, its franchise; but these three things, several in the ownership of the company, are united in the ownership of the shareholders. The share stock covers, embraces, represents all three in their totality, for it is a business photograph of all the corporate possessions and possibilities" (*People ex rel. Union Trust Co.* v. *Coleman*, 126 N. Y. 433, 438).

When dividends are declared the amounts of the dividends are separated from the corporate property and are received by the shareholders respectively as their separate property. But until dividends separating money or property from the corporate assets in this way are declared, the shareholders continue to retain the interest in all these assets represented by their stock, the extent and value of their aggregate interests depending not upon the sums originally contributed to capital, but upon the extent and value of all the assets of the corporation, including its accumulations, after deducting liabilities. When a so-called 'stock dividend' is declared, the company does not distribute but continues to hold the property upon which the stock issue rests. Its undivided profits previously invested in the enterprise continue to be so invested. Instead of being a "dividend" in any proper sense, the effect of the action is that there shall be no dividends of the accumulations capitalized. The aggregate interests of the

shareholders remain unchanged and their proportional interests remain unchanged.

Thus, a 'stock dividend,' or increase of capital stock against surplus accumulations, accomplishes two things:

(1) The amount represented by the 'stock dividend' is permanently classified so that it cannot be paid out as dividends.

(2) The number of shares is increased without affecting the title of the corporation to any part of the corporate property and without adding to the ratable interests of the shareholders.

Upon a liquidation immediately before the 'stock dividend' the shareholder would have received precisely the same amount as he would have received upon a liquidation immediately after the 'stock dividend'. So far as the paper, or stock certificate, issue is concerned, it is an evidence of an interest already owned and permanently capitalized.

It is frequently said that the shareholder secures new rights or advantages. But the contention will not bear analysis. We are concerned here with the *property interest* represented by the stock in question upon which the plaintiff had been taxed. This stock represents (1) the right to have the corporate property managed according to the fundamental compact or contract of membership; (2) the right to receive dividends, when duly declared, that is, amounts separated from the corporate assets and vested in the shareholders individually; and, (3) the ratable interest in the aggregate of the corporate assets to which the shareholders would be en-

titled upon liquidation.

With respect to management, the shareholders rights are unchanged save to the extent that the accumulated surplus, which is represented by the new stock, is no longer subject to the discretion of the directors in distribution but is classified as capital and must be retained by the corporation as such.

With respect to dividends that may be declared upon this stock,—whenever any such dividend is declared and there is thus segregated from the corporate property an amount which the shareholder receives, he will be taxable accordingly.

With respect to the right to receive his ratable interest upon a winding-up, there is no change.

It is argued that the effect is the same as though a cash dividend had been declared, and its amount received by the defendant-in-error, and she had then invested this amount in the new stock. The same argument was made unavailingly in *Towne* v. *Eisner*. It is manifest that the two things mentioned, instead of being the same, are different, both legally and practically. When the cash dividend is declared and the amount is received, the shareholder obtains something which he owns and which he may reinvest or not as he pleases. He receives property in his exclusive ownership, and he exercises the freedom of choice. In the case of a 'stock dividend', he obtains nothing but an evidence of what he already owns; he has no freedom to invest or not invest; and the investment is permanently capitalized. This distinction was pointed out in *Davis* v. *Jackson*, 152 Mass. 58.

It is argued further that the certainty that these earnings of the corporation could thenceforth never be distributed as dividends, was a valuable assurance of the continued solvency of the company to the stockholder, and that this assurance was subject to a tax as income of the individual shareholder. But before the 'stock dividend' the shareholder's interest in the corporate assets could not be taken away, except through mismanagement or losses, and his interest continues to be subject to these contingencies as before. Previously, if there were distribution in cash, he would receive his dividend and own the amount. The proposition that the certainty that a man will never receive a given fund is equivalent to his actual receipt of that fund will appeal less to the shareholder's sense of logic than to his sense of humor.

Nothing could be a greater fallacy than to treat a recipient of a 'stock dividend' as being in the position of a recipient of a like amount of cash. In fact, he may never receive anything but a piece of paper, for the corporation may become insolvent and his stock worthless. In the present case, the shares had a market value and, as might be expected, the market value of all the shares remained unchanged. But it may be, and frequently is, the case that at the time of the 'stock dividend' the shares do not have a market value, or have a market value below par. The corporation may have surplus, and may capitalize it, but it may be engaged in a hazardous enterprise or for other reasons

its shares may not have a value corresponding to their book value. Illustrations of this may readily be found. There are today selling on the New York Stock Exchange shares which are below par, although the corporation has a surplus and could issue 'stock dividends'. Such 'stock dividends' would not only make the shareholders no richer, but the latter would have to pay a tax, under the contention of the Government, as an income tax upon an assumed or par value which was greater than the actual value of the shares themselves. The fact that the corporation may have accumulated profits, or surplus, does not mean that the shareholders can realize that amount. It is a misnomer to call 'stock dividends' a *distribution*; it is not a distribution but a capitalization. The capitalization of surplus does not transfer it to shareholders. If the new shares have market value, the 'stock dividend' will make the shareholders no richer, and, if the shares have no market value, the shareholders will not be able to realize even that which they are falsely assumed to have received.

The argument that a 'stock dividend' is income fails to distinguish between the effect of the dollar sign printed on the certificates of stock as indicating the amount contributed to "capital", and the interest of the shareholder in the aggregate corporate assets, with which this dollar sign, or the par value of his shares, has nothing to do. As to the corporation, its net assets are divided into two groups, "capital" and "surplus", with different legal attributes, and the dividing line between the two groups is shown by the nominal or par

value of the company's stock, or the amount of the contributed "capital".

In the case at bar, for example, the Standard Oil Company of California had $49,686,656 of capital stock, and $94,538,919. of assets. The $49,686,656 of capital was divided into 496,866 shares of the par value of $100 each. These $49,686,656 represented in a general sense a trust fund to be used by the corporation in the conduct of its business and for the payment of its debts; none of it could lawfully be separated from the company and paid to its shareholders. The other $44,852,263 of its assets represented surplus which the company was free to dispose of in any manner that it saw fit. There were 496,866 shares of stock outstanding; the dollar mark on each certificate, indicating the par value of each share; was of importance in indicating the amount of the contributed capital stock, and therefore the dividing line between these two groups of its net assets.

But there was no such distinction with regard to the shareholder's interest in the aggregate corporate assets. As to this the dollar mark on his certificate was immaterial. Each share of stock represented 1/496,866 part of the net assets of the corporation, and those assets might amount to $1,000,000 or $50,000,000, and this was true whether his stock had a nominal par value or whether, as is permitted in various States, it was 'no par value' stock.

When it is argued that in receiving a 'stock dividend,' a shareholder receives from the corporation something of value which must therefore be income, there is an inaccuracy in terms. If I exchange a two-

dollar bill with the money changer for two one-dollar bills, I have, it is true, received from him something of value, but my property interest remains entirely unchanged, and I have surely not received any "income."

If the Standard Oil Company of California had outstanding 496,866 shares of capital stock of the nominal or par value of $100. each. and had issued in exchange therefor 993,732 shares of the nominal or par value of $50. each, each shareholder would have received an increased number of tangible evidences of his ownership in the assets of the corporation. He would have no greater interest in the assets of the corporation than he had before, and the dividends he might thereafter receive on his holding of $50. shares would be just as large as if he received dividends on his original $100. holdings. But the Government would not contend that such an alteration of the shareholder's certificates constituted income.

It undoubtedly will be conceded by the Government that if a corporation having a million dollars of capital and with no surplus, waters its stock and issues a 50 per cent. 'stock dividend' to its shareholders, the new stock not representing an increase of assets would not constitute taxable income in the hands of the shareholder; the receipt by the shareholder of certificates of stock having an increased nominal or par value does not increase the stockholder's real interest in the corporation, and therefore the change does not constitute income.

The effect of this concession cannot be overcome. It is conceded that the increase of the number of shares into which the assets of the corporation are divided, or the issue of a new series of fractional certificates does not constitute income to the shareholder if the corporation has no accumulated surplus, even though the nominal or par value of the shares of stock owned by each shareholder is thereby increased. It is conceded that mere increase in the number of shares into which the capital of a corporation is divided does not constitute income, and this regardless of the question whether the corporation has available accumulated surplus or not. And it is just as true that the shareholder's interest in the aggregate corporate assets remains unchanged when there is an increase of stock based on accumulated surplus. The change is simply that the amount is permanently capitalized so that it cannot be distributed without liquidation; on liquidation the shareholder would receive no more than before.

Of course the salability of the new shares presents no more argument for the existence of "income" than does the salability of the old shares at an increased price because of the accumulated earnings back of them. A sale in either case would have the same effect.

If one had 9,000 shares previously, and received 4,500 additional shares through a 'stock dividend' based on surplus accumulations he, of course, could sell any portion of the total 13,500 shares. And if he sold 4,500 of the 13,500 shares he would receive the equivalent in cash. But he could have realized the same

amount prior to the 'stock dividend' by selling 3,000 shares of his original 9,000 shares. His intrinsic interest is the same, and the transaction has not affected its value.

The defendant-in-error has received new shares but her old shares represented precisely the same value; in fact she is no richer at the end of the year than at the beginning; and as in all the cases discussed above, the one thing necessary has not taken place—realization of gain. She may never realize any gain. If dividends are received *on* the new shares, so that she does receive gain in this way she will be taxable on such dividends. The defendant-in-error objects to the payment of a tax as having received some income when just the opposite thing has happened—she has been definitely assured that she will not receive it in the way of dividends. If she sells any of her shares, she will be taxable on whatever profit is made.

FOURTH: The Tax in question is an income tax and cannot be sustained as anything else.

There is just a suggestion in the Government's Supplemental Brief (p. 41) that the tax might be sustained "as an excise tax on the privilege of receiving dividends", even although it could not be sustained as an income tax. The Government merely makes the suggestion in two lines, without argument, and we may assume that if the Government had any confidence in the point it would have been presented in a different way.

However, it is apparent that there would be no basis for such a contention.

The tax in question is not an isolated tax which is sought to be construed as an income tax for the purpose of defeating it.

The tax not only is laid as an income tax but it is laid on the 'stock dividend' as a *portion* of the taxable income of the taxpayer.

The tax is a graduated surtax. The rates are graduated not according to the amount of the 'stock dividend', whether considered with respect to par value or, as the statute says, cash value, but according to the *total net income* of the taxpayer, of which the stock dividend is directed to be considered a part. Thus if A receives a stock dividend of shares having a par value of $25,000 and his total net income, including this $25,000 of stock, is deemed to be $1,000,000, he is taxed upon this sum of $1,000,000 as his total net income at rates increasing upon a graduated scale, paying on the last $500,000 at the rate of eleven per cent. In this way the tax is laid upon the sum of $25,000, the par value of the 'stock dividend', as a part of his income. On the other hand if B received a similar 'stock dividend' of $25,000 and had other income making his total net income $50,000, he would be subject to a surtax the highest rate of which would be but two per cent. C, who had the same 'stock dividend' but received shares of $15,000 par value and had no other income would be subject to no surtax at all. The figures we have here given are drawn from the Act of 1916; under

the later Acts the disproportion would be greatly increased.

Of course it is impossible to consider a tax of this sort as anything but an income tax. It is laid upon the 'stock dividend' as constituting income in itself and the rates are fixed by reference to the total net income of the taxpayer.

As the 'stock dividend' is not income the tax cannot, we submit, be sustained.

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"Are Stock Dividends Income?"

By Professor Edwin R. A. Seligman
Columbia University.

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Submitted with Brief for Defendant in Error in

No. 318.—October Term, 1919.

SUPREME COURT OF THE UNITED STATES.

MARK EISNER, Collector, etc.,
Plaintiff-in-Error,

against

MYRTLE H. MACOMBER,
Defendant-in-Error.

(Reprinted from American Economic Review, Vol. IX, No. 3.)

ARE STOCK DIVIDENDS INCOME?

By Professor Edwin R. A. Seligman,
Columbia University.

Among the difficult problems raised by our income tax is that of the nature of stock dividends. Under the act of 1913 they were held to be income by an interpretation placed on the law by the Department of Internal Revenue. In the act of 1916 they were made specifically taxable as income. Some time after the enactment of this law the Supreme Court decided that the administrative interpretation of the act of 1913 was erroneous,[1] and that the word income as used in that act did not include stock dividends. The question now arises whether the act of 1916 is constitutional in declaring stock dividends to be income. It is being hotly disputed in a case[2] now pending and which, although already argued once, is to be reargued in the autumn of 1919. We have accordingly deemed it wise to consider the problem purely from the economic point of view, especially as the subject has hitherto received comparatively little attention.[3]

In order to prepare the way for the discussing we must travel over more or less familiar ground; but it will, we hope, soon appear that the subject deserves a

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[1] *Towne* v. *Eisner*, 245 U. S. 418.

[2] *Eisner* v. *Macomber*.

[3] The only discussion of the topic is the short colloquy between Professor F. R. Fairchild and Mr. H. H. Bond in the *Bulletin of the National Tax Association*, vol. III, pp. 161-3 and 237-243. Professor Davenport has also contributed a brief note in the same *Bulletin*, vol. IV, p. 53. Professor Irving Fisher does not deal with the problem in *The Nature of Capital and Income*.

considerably closer analysis than it has yet received. We shall therefore start out with the concepts of income and of capital.

1. *What is Income?*

The most natural definition of income is all wealth that comes in. This, however, obviously is entirely too vague. The things that come in are fundamentally utilities and services. We desire things, at bottom, because of their utility. They can impart this utility only in the shape of pleasurable sensations or satisfactions. These alone constitute true income. If the satisfaction comes from a human effort we speak of a service; if it comes from material things or relations we speak of a use or utility. The satisfactions are afforded by the services of human beings and the utilities of material things or relations. Income is the inflow of satisfactions from services and utilities. Income is therefore fundamentally pleasure or benefit income.

When these services or utility-affording commodities are restricted in quantity, and cost some effort to procure, they acquire a value. Since we must economize in their enjoyment and use, we speak of them as economic goods and services. Economic value or value in economic life is therefore to be distinguished from other forms of value like æsthetic or moral value. In civilized society this value has come to be estimated in terms of money. Income is accordingly now used to denote the inflow or revenue in money. Speaking more broadly, however, it may be said that in a society based on money transactions income denotes any inflow of satisfactions which can be parted with for money. It may not be money income, but it must be capable of being transmuted into money income.

The second characteristic of income is that it denotes a flow or succession of such satisfaction, expressed in money or money's worth, during a period of time. If there is only a single utility or a unique service, we speak of an accession, rather than of a succession, of satisfactions. But whether there be one or many, we think of their coming in during a period of time. The quality of periodicity is essential. Thus, income must be either annual, or monthly, or daily income, or income for some other period of time.

Thus far the ordinary analysis has gone. There still remain, however, other criteria of income.

Since the real wealth of an individual or a community consists of this inflow of satisfactions that we call income, it is clear that the satisfaction must be realized before we can predicate of it the quality of income. The satisfaction may come from the repair of a broken stove, from the occupation of a house, from a foal born to a broodmare. The plumber affords a service, the house yields an immaterial benefit, the mare produces a commodity. The employer or owner can sell the serices of the plumber, rent the house, or dispose of the foal. In each case he secures a money income. He is able to do this because the other party receives a corresponding income in the shape of satisfaction. The stove owner has a good fire, the tenant enjoys shelter, the purchaser of the foal acquires a saddle horse. The first party's money income is correlative to the second party's pleasure income which, if not money, is money's worth.

If now the plumber falls ill, if the house is unrented or untenanted, if the foal is stillborn, there is no income to the employer or owner, because nothing is realized. The plumber continues, perhaps, to be paid by the month, the house still commands a market price,

the broodmare is still worth a definite amount, because in each case a steady income is anticipated. It is only when the failure of the income is repeated that the wages of the plumber and the value of the house or the mare will fall. On the other hand, the repair to the stove may be so badly made that the stove is still useless; the house may turn out to be so leaky as to be uninhabitable; the foal may be so defective as to be unusable. The gain which it was thought would be enjoyed has not been realized. There is in truth no income. And under a proper legal system it is possible to recover what has been paid so that the employer, landlord, or horse-trader likewise loses his income. The net result is that an unrealized or imaginary income is not an income at all. Just as a true satisfaction is realized satisfaction, so true income is realized income. In order to constitute income, the anticipated or putative gain must be not only realizable, but realized. If it is not realized, there is no income. Realization is a necessary attribute of income.

The next characteristic of income is that it is something distinct and separate from the person or thing that affords the income. Where the income consists of concrete objects, this is quite obvious. Each foal is separate from the mare and cannot possibly be confused with its mother. The succession of separate foals constitute the income and perhaps the only income from the mare. The mare is, so to speak, a bundle of inchoate or unborn foals. When the foal is actually born and separated from its mother, it constitutes the income from the mother; just as the fruit separated from the tree is the income from the tree. The same thing is true, however, in the other cases. The income of the house is really separate from the house itself. The house is to all intents and purposes a bundle of

inchoate utilities: it will afford these utilities from year to year. The owner may durng any given period dispose of the utility while retaining the title to the house. The rental that he receives by separating the actual utility from the bundle of inchoate utilities that we call the house constitutes his income from the house. Separation is of the essence of the enjoyment. The same finally is true of the plumber. His skill is indeed a part of him; but in order to secure the income that we call wages he must transmute his skill into something outside of, and separate from, himself. At a particular period he may render a service in repairing the stove; the service is then something separate from the man. If he disposes of the service, he enjoys an income. But he cannot secure the income without performing—that is, divesting himself of—this service. Separation, again, is of the nature of the transaction.

Thus in every case, whether we are dealing with human services, immaterial utilities or concrete objects, there can be no income unless there is a separation from the individual or the thing that affords the service of the utility. Separation, like realization, is a necessary attribute of income.

2. *What is Capital?*

As against the income, which, as we have seen, is the satisfaction afforded by services or utilities, is the capital. When we buy anything, we buy the right of securing such a satisfaction or stream of satisfactions from the commodity which embodies the utilities. Every commodity is a store of such future or inchoate satisfactions. Since human beings are no longer bought and sold, and since wealth exists for man rather than man for wealth, we can no longer buy the source

of human services, although we buy the services themselves. We can only buy things or the source of non-human utilities. The process of valuation through which we assign a capital value to this complex of future anticipated income [illegible] and through which the flow of satisfactions is transmuted into a fund, is called capitalization. At a given time the object or relation which affords the utilities or the income is called the capital. The capital possesses a value which reflects our estimate of the succession of anticipated utilities or income. Nothing would have any capital value if it possessed no income value.

Common usage distinguishes between a particular piece of capital (technically known as a capital good) like a house or a machine, and the fund of capital which represents the translation into money of the value of the particular pieces of capital. These may wear out and disappear; but, if they are replaced by others, the fund remains intact. As has been so well said, the fund of capital is like a mill pond: the drops of water flow in at one end and out at the other. But the pond itself, although continually changing, remains at a level, with the same volume of contents. The fund of capital is the mill pond: the particular pieces of capital are the drops that are continually flowing in and out of the pond. Capital, in the sense of a fund, is used to designate the *caput* or principal sum of money from which a revenue is expected.

Income is spoken of as a result of the capital. In reality, capital or capital value is a result of the income or income value. Capital, again, is spoken of as the source of income. In reality, the income or income value is the source of capital or capital value. Physically, the fruit is a product of the tree; economically,

the tree has a value only because the fruit has a value. To all intents and purposes it is correct to say that capital produces an income; strictly speaking, however, the capital is produced by the income, or at least the capital value depends on the income value.

The real distinction between income and capital as the embodiment or the measurement of wealth, therefore, is that income represents a flow or stream of utilities or money, and capital represents a fund or stock of utilities or money. The flow or stream is periodic; it represents a succession of utilities or money during a period of time. The fund or stock is the accumulation of such utilities or income at an instant of time. Income is expressed in terms of a flow; capital in terms of a stock. The capital value of anything at any instant of time is primarily the result of adding together the present worth of each and all of the anticipated successive income values. The income is primary; the capital is secondary.

3. *The Relation between Capital and Income*

We are now in a position to study some of the relations of capital and income.

In some cases there seesms to be no distinction between the two. This is of course not ordinarily true. The value of anything, is, as we have seen, ultimately derived from the satisfactions or uses which it affords. Some things, like a city lot, are permanent and afford a use in perpetuity. The capital or selling value of the lot, however, is not a summation of all future income or rental values from the lot. By the very constitution of human nature we lay more stress on present than on future enjoyments; our present estimate of future uses becomes fainter as the use recedes into the future, until

the present value of a very distinct use vanishes entirely. The selling or capital value of a lot is accordingly only twenty or twenty-five times the rental or income value. Land is worth, as we say, about twenty-five years' purchase. Other commodities are less permanent, and are gradually worn out by use. The distinction between the capital and the income value is then considerably less, as in the case of an automobile. The man who rents out an automobile must secure in the first year as income perhaps one third or one half of its capital value.

Finally, there are commodities which afford only a single use; the use of an ordinary article of food consists in its consumption. In this case the distinction between capital and income disappears. Capital, as we have seen, is a capitalization of incomes, a summation of our present estimates of the value of all future anticipated uses. But if there is only a single use, there can be no summation of successive uses. There can be no capitalization of a single use. Since, however, we speak of capital as a stock of wealth existing at an instant of time, while income is the flow of wealth during a period of time, the apple which affords only a single income is popularly regarded as capital. Yet its price, although ordinarily called a selling price, might equally well be called a rental price. In charging for its use, we charge for the apple itself. The capital and the income coalesce.

In this case, therefore, we must qualify the statement made above that separation is of the essence of income. If there is no difference between capital and income, we cannot separate the two. In all other cases however, that is, in the great mass of wealth (except that destined for immediate and total consumption),

the distinction holds good. Income is something separate from capital; and if capital be regarded as the stock which yields the income, the enjoyment or money's worth in the shape of gain must, in order to constitute income, be separated from the capital.

It follows from this that if the income is separated from the capital and if we desire a continuance of the income, the capital must remain intact. In any particular piece of capital, this does not, of course, happen of itself. If the commodity is permanent, like a city plot, the capital indeed remains unimpaired. But in the great mass of cases the commodity gradually disappears through use. Some things are consumed in a short time, others last a longer time; but in almost all cases there is a wear and tear which, if allowed to go unchecked, finally renders the commodity useless so that it will cease yielding an income. There will be no net revenue because the cost of repairs will ultimately equal the gross returns. In actual life we sometimes guard against the results of such depreciation by instituting a sinking fund. Instead of spending all the earnings, we set aside an annual sum which will exactly counterbalance the depreciation, so that at the end of the period the accumulated fund will sink or offset the outlay incurred to replace the commodity.

In order to estimate the real net income from a piece of capital we must therefore deduct from the earnings the amount of the annual depreciation charge, which will vary with the durability or permanence of the commodity in question. Otherwise, in separating the income from the capital we should be depleting the capital. Income in the true sense of net income is that which is separated from the capital, while leaving the capital intact. As it has elsewhere been defined:

"Income as contrasted with capital denotes that amount of wealth which flows in during a definite period and which is at the disposal of the owner for purposes of consumption, so that in consuming it, his capital remains unimpaired."

4. *Income and Accretion to Capital*

We are now prepared to consider a more difficult problem. If my income increases, there is undeniably an increase in my wealth, or a net gain. This increase of wealth or gain, however, may also show itself in a change of my capital or my assets. In that case we speak of an accretion to capital or a capital increment. How, now, are we to determine whether a particular gain is income or accretion to capital. This question needs a more careful analysis than it has hitherto received.

In the case of a concrete commodity the capital or selling value may change for three reasons:

In the first place the income may not be consumed, but saved and added to the capital. There is indeed a difference here between money and money's worth, between a fund of capital and piece of capital. If I have a fund of capital, as $100, and decide to save the income of $5, I shall have at the end of the year $105, and with each ensuing year correspondingly more capital. This accretion to capital is clearly nothing but accumulated or reconverted income. The income has been realized and separated from the principal. While indeed it is now again merged with the principal, it is easy to keep the two sums separate and distinct. No

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[1] Seligman, *The Income Tax*, p. 19.

one can question the fact that the gain, even though added to the capital, is pure income.

In the case of money's worth or utilities the matter is a little more complex. The income of many things is not embodied in an object, but consists of utilities that are incapable of being accumulated and that must be enjoyed or consumed at once. A house is of use only for habitation. We cannot make the house more valuable by postponing or deferring its use. We cannot reconvert the use or income into capital. If the use is not enjoyed, it is lost. There can therefore be no capital increment through a postponement or accumulation of income.

Where the income consists, however, of material objects capable of preservation, the matter is simple. The farmer's crop is his income. If he elects to add his crop of cotton to his previously existing stock (which he may be holding for a rise), this increment of capital is undeniably income. The new crop is something separate from the old stock. In the same way, the owner of a herd of cattle may decide not to sell his yearlings. Although they may be merged with the herd, however, they are none the less separate; for it makes no differecene whether he keeps them in a distinct enclosure or lets them pasture with their mothers. The increment in the value of the herd is income, because it is both realized and separated.

Finally, there are cases where the income, if not originally separated, cannot be kept separated. The best example of this is a growing forest. The income of a forest is the annual yield of timber. The trees of a certain size may be cut yearly, leaving the forest intact. With proper forestry there will be a steady and regular cut of timber, what is lumbered in any year being made good by the growth of the remaining and on-

coming trees. If, however, the trees are not cut, the forest becomes more valuable—up to a certain point at least. What would have been income has been converted into capital increment. But this capital increment is not income, because it has not been separated and because it is not capable of separation if uncut. When the trees are ultimately cut, the gain undoubtedly becomes income. Up to that time, however, the increase in the value of the forest is only inchoate income. What is done with the particular trees therefore determines whether they are income or capital. To the owner of the forest there is an increment of wealth in each case; but from the economic point of view there is a distinction between the increase in the form of income and the increase in the form of capital. If the income is immediately enjoyed or dissipated, the increase of wealth disappears in the enjoyment; if the enjoyment of the income is postponed or deferred, the increase of wealth is not dissipated. In the one case we have spending, in the other saving. Capital can be increased only by postponement of enjoyment. Modern life with its mastery of science over nature enables the community not only to spend more for the conveniences and luxuries of life, but also to save more and thus to accumulate capital.

We see then that if the income has been actually realized and separated and then again added to, or reconverted into, the capital, it remains none the less income although called capital increment. But if the income is simply unconsumed or postponed, without being actually realized and separated, the resulting capital increment is not income. What we are dealing with in such a case is inchoate, not real, income. Realizability is not realization; separability is not separation. The gain in the form of accretion to capital is income only

when it is the result of adding actually received (i.e., realized and separated) income to the capital. Otherwise the gain is inchoate income, to become real income only when it is actually realized.

The second case of a change in the value of capital referred to above on page 523 is that due to a change in the income from the capital. The demand for the particular satisfaction or commodity may decline; ostrich feathers may go out of fashion; Sicilian oranges may no longer command a market in New York in competition with Florida fruit. This dimunition in income will be at once reflected or amortized in a reduction of the value of the capital. If ostriches are raised primarily for feathers, their value will fall; if the Sicilian lands are of little use for other crops they will decrease in value, as indeed has actually happened. On the contrary, an increase in the income will be capitalized into an enhancement of the capital. If dry farming or irrigation causes two blades to grow in place of one, not only is the income from the land greater, but the land itself will rise in value. Capital is capitalized income. In such cases, therefore, there is no difficulty. We are in the presence of two separate phenomena—an increase of income and an increase of capital. The one is the result of the other, but there is no danger of their confusion. The owner of the commodity enjoys two increments or gains—a capital gain and an income gain. The gain in the value of the capital is not income, because it is not separated and realized.

When, instead of a particular commodity or capital good, we deal with a fund of capital, the same is true. If the dividends of a stock increase, the market price of the stock will rise. Both capital and income are enhanced in value. But the augmented value of the stock

is not income as long as the stock is not sold, *i.e.*, as long as there is neither realization nor separation.

In the third place a change in capital may supervene without any change in the income. A plot of land may rent at the same figure before, but a speculative move in the market may enhance its selling price. A stock may become valuable for purposes of control, even though the dividend rate remains unchanged; and its market value will quickly rise. In all these cases we have a capital increment with no change in income.

In reality, however, the discrepancy in many such cases is less than it seems. The present income, it is true, remains the same, but there is an expectation of greater income in the future. The boom in real estate is based on the idea that the rental value of the land will rise. The control of the stock is sought for in the hope ultimately of securing a gain through the augmented returns. Capital is a capitalization not simply of present or actual income but of the present worth of all future anticipated incomes. There can be no permanent change in the value of the capital unless there is at least an anticipated change in future income.

It remains true, nevertheless, that there may be temporary and ephemerel fluctuations of market price in complete disregard of future or anticipated incomes, and where the particular commodity or security is desired for other purposes than the income immediately to be derived therefrom. It is equally true that no small part of business profits is due to such fluctuations of price. Here again, however, there is no danger of confusing capital increment with income. For, as in the preceding case, the gain derived from such fluctuations becomes income only when the attributes of separation and realization are present. If the house appre-

ciates in value because some one desires it for a particular purpose, the increase is income if I sell the house. But if I do not dispose of the house, the gain is only an inchoate gain, not a realized gain. Since there is no separation and no realization, the capital increment does not constitute income.

Thus all cases of appreciation of capital may be resolved into three types:

1) The capital increment is the accumulation of past income.

2) The capital increment is the result of augmented present and future income.

3) The capital increment is independent of change in the income.

In the first case the capital increment is undoubtedly income. In the two other cases it becomes income only when actually realized and separated from the principal. Until then it remains inchoate income, not actual income; a paper gain, not an actual gain. Thus in all three cases realization and separation constitute the true criteria of income.

5. *What is Taxable Income?*

When income taxes were first introduced, economic science was only in its infancy and the above analysis of the relations between capital and income had not yet been worked out. We therefore find a considerable confusion and diversity in the earlier income tax laws of various states, some survivals of which have persisted even to this day.

In the first place, income was commonly limited to money income. Difficulties, however, soon arose in the case of farmers consuming their own produce and individuals residing in their own houses. The

truer conception of income as benefit income was only slowly adopted. If I own my house and receive no money income, I am not taxed under the present law in the United States; if I sell the house and devote the income of the proceeds to renting another house of precisely the same character, I am compelled to pay the income tax. Yet the economic situation is essentially the same, and the similarity was recognized in the Civil War income taxes.[5] In the case of farmers' produce our present law occupies a middle position: crops consumed by the farmer or his family are held not to be income, but the expenses involved in raising the crop cannot be deducted. These inconsistencies, which are no doubt retained in the law partly for administrative reasons, would disappear if it were recognized that income is not only money, but money's worth.

Secondly, we find in the original conception of income the idea of regularity. Only those incomings or net money receipts which were regularly received in the course of economic activity were considered income. Thus for a long time occasional earnings from gambling were not considered income, as was the case also with chance finds or gains. If, however, these finds, as *e. g.*, of precious metals, were the result of continued and regular effort they were held to be taxable income.

This idea of regularity gradually disappeared as the true nature of income came to be recognized. But the survivals of the old idea are still occasionally to be found. Inheritances, for instance, are today scarcely anywhere deemed to be taxable income. From the point of view of the individual, however, they constitute income, even though it be accidental and not regular income. As a consequence they are now almost every-

[5] *Cf.* Seligman, *The Income Tax*, pp. 443-445.

where separately taxed, although not under an income tax law. For the real economic justification of the inheritance tax on the share going to the recipient (as distinguished from the tax on the estate of the decedent) is that it constitutes accidental income and thus augments his ability to pay. Again, in many income tax laws, like our own, gifts are held to be capital or corpus and not income, evidently on the theory that they do not constitute regularly accruing gains. If the gift, however, were made periodically, an interesting question would arise.

In general, then, it may be said that the element of regularity as an essential constituent of the concept of income has well nigh disappeared. If I receive a thousand dollars for particular services this year and nothing in previous or subsequent years, it is none the less held to be income, even though it be irregular. The old conception of regularity, however, as we have seen, still survives in part.

In the third place, the original conception of income was limited to the usufruct of a commodity, without allowing for a gain derived from the disposal of the commodity itself. Later the conception was broadened, but only in part. In England, for instance, the decision was influenced by the idea of regularity, just discussed. That is, gains derived from the sale of property are even today considered income only if made in the ordinary course of business. If an individual, not in the real estate business, sells a particular piece of land, the gain would not be taxable as income because it constitutes only an occasional or unique transaction. In England such an irregular gain would be considered accretion to capital, not income. In the United States, however, as in many other places where the broader concept of income has come to be recog-

nized, gains derived from sales, whether occasional or not, are held to be taxable income. To this procedure there is no objection from the modern economic point of view.

Thus the newer conception of income comprises not alone money, but money's worth; not alone regular, but irregular receipts; not alone gains from a usufruct, but gains from the disposal of the thing that yields the usufruct. It is simply a survival of old errors, fortified no doubt by the desire to avoid practical administrative difficulties, that in England the gain from the sale of an isolated piece of property is held to be accretion to capital and that in both England and the United States the rental value of a house is held not to be income and that the reception of an inheritance is regarded as a capital increment.

In one point, however, almost all modern income tax laws are agreed. While there is still, as we have seen, a difference of attitude in the treatment of gains derived from sales, there is but little difference in the treatment of other gains. The distinction here is the one adverted to above between realized and unrealized gains. As we have seen, unrealized gains are inchoate gains, and inchoate gains are not income.

If I own a plot of land and secure no tenant for it, I receive no income and am nowhere subject to income tax. In some countries land is indeed taxable on its rental value; but rental value is not income. Since there is no gain at all, it is not subject to income tax. If, however, in the same year the value of the land rose, the owner would undoubtedly feel that he was wealthier. But would this appreciation in the value of the land constitute income? The answer everywhere is in the negative; and properly so, because we are in

the presence of an unrealized gain. The land may have appreciated in value by the tax date; but it may equally well depreciate immediately thereafter. If the appreciation is realized through the sale of the property, there is of course a realized gain which is correctly held to be taxable income in the United States (although not in England). Again, if I sell the land and invest the proceeds in something else which then falls in value during the same taxable year, I am permitted to set off my loss against my profit. In that case there is no net gain and therefore no taxable income. The reason why a mere unrealized increase in the value of the land does not constitute income is primarily because of the uncertainty as to whether this particular consequence may not happen. In the same way, if I own securities which rise in value, there is a realized gain or taxable income only when the securities are sold.

We may put the conclusions briefly as follows:

Capital increment is a gain only when realized.
A realized capital increment is income in the wider sense.
An unrealized capital increment is not income, but a mere appreciation of capital.

As indicated above, the real point is the separation of the increment from the capital. This separation is necessary in order to constitute income. The increment when separated is income; the increment unseparated remains capital. Separation and realization are of the essence of the transmutation of capital into income. The capital as such remains intact: the increment or capital gain when actually realized and separated constitutes income.

6. *The Economic Nature of Stock Dividends*

We are now prepared for an analysis of the economic nature of stock dividends. This can be best introduced by taking an assumed case of a corporation with a capital of $100,000 divided into 1,000 shares, each worth par and owned by ten stockholders, each of whom owns ten shares of stock worth $10,000.

During the taxable year the corporation has net earnings of $50,000, on which it is of course subject to income tax. On the last day of the year, December 31, the stockholders hold a meeting in order to decide what to do with the $50,000. Three courses are open to them:

A) They may declare a cash dividend.
B) They may turn the earnings into surplus.
C) They may declare a stock dividend.

What happens in each of these cases?

A) After a cash dividend of $50 is declared on each share, the capital remains at $100,000, the number of shares is still 1,000, and the stock is still worth par, other things being the same, while the $50,000 is distributed to the stockholders in dividends, each of the stockholders receiving $5,000 as his dividend or income.

B) When the earnings are turned into surplus, the capital is now $150,000, the shares are still 1,000 in number, but each share is now worth $150. Each of the ten stockholders who continues to own ten shares now has property worth $15,000.

C) If a stock dividend of $50 is declared in additional shares to each owner of $100 worth of shares,

the capital is now $150,000; the number of shares is now 1,500 instead of 1,000, and the value of each share is still $100. Each of the ten stockholders now possess fifteen shares, instead of ten, and his investment is worth $15,000.

There are now two possibilities. Either (*a*) the earnings have been gradually accumulated during the year, with periodical statements open to the public, or (*b*) the knowledge of the increased earnings is kept secret from everyone until December 31, when action is taken.

What now will be the relative economic situation in these three cases?

A, *a*) The case of a cash dividend where the earnings have been known to accumulate during the year. Here the stock will gradually rise until, with the expectation of a $50 dividend, it will be worth on December 31, $150. Immediately after the declaration of the cash dividend, the stock will again fall to par. In actual life, indeed, there may be an interference with this normal result. As a matter of fact, each share may be worth a little less or a little more than $150, depending upon the market estimate of future prospects. Additions to surplus are often not expected to earn quite as much as the original investment, in which case the price will be less than $150; on the other hand, if continued large earnings are anticipated, the price may be above $150. Apart from these countervailing influences of the market, however, the situation as reflected in the statement of the beginning of this paragraph may be accepted as the normal one. In the same way the declaration of an extra cash dividend may lead to an expectation of continued earnings on the same scale, so that the price of the stock will not finally fall quite to

par. But for purposes of simplicity this hypothesis may be eliminated, and the situation as described above may be considered the typical one.

A, *b*) If the earnings are unknown and unsuspected, the stock will naturally remain at par and the declaration of the cash dividend will not change the value of the stock (except in the same eventuality as before).

B, *a*) The case of addition to surplus, where your earnings have been accumulated throughout the year and have been well known to everybody. The stock will accordingly rise gradually until on December 31 it will reach $150. After the addition to the surplus the stock will remain at that figure.

B, *b*) If, on the other hand, the earnings have been unknown and unexpected, the stock will remain at par until December 31, when it will jump to $150 and remain there, with the same practical qualifications as above.

C, *a*) In the case of the stock dividend, where the earnings have been accumulated during the year and their existence known to all, the stock will as before rise to $150 by December 30. After the declaration of the stock dividend, the stock will on December 31 fall to par, just as in the case of the cash dividend.

C, *b*) If, before the declaration of the stock dividend, the earnings have been unknown and unsuspected, the value of each share will, precisely as in the case of the cash dividend, remain at par.

What now is the economic consequence of all this?

In A, the cash dividend, we are undoubtedly in the presence of actual income accruing to the stockholder. The cash paid to the stockholder is separated from the assets of the corporation; the gain, accruing to the stockholder, is actually realized by him. Both realization and separation are present.

In B, the addition to surplus, there is an appreciation of capital either (*a*) before or (*b*) after December 31. But this manifestly does not constitute any income to the shareholder. For, in the first place, there is no separation of the gain. It is merged into, and coalesces with, the surplus. And, secondly, there is no realized gain to the shareholder. His investment is worth more; but it has not been realized. It is like the appreciation in value of a house or a piece of land. There is no income because there is neither realization nor separation. It would be mere folly for a country to attempt to tax the shareholder because of an increase in the surplus of the corporation. The increase is indeed income to the corporation or rather it represents the disposition of the corporate income; but it is not income to the stockholder.[6]

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[6] The one striking example of this error is the case of the Civil War tax of 1864, which provided (in Sec. 117) that "the gains and profits of all companies, whether incorporated or partnership, other than the companies specified in this section, shall be included in estimating the annual gains, profits or income of any person entitled to the same, whether divided or otherwise." Under this section the Supreme Court held in *Collector* vs. *Hubbard* (12 Wall. 17) that the wording of the act justified the taxation to the individual of his share in the undivided corporate profits.

In extenuation of this law, however, the following facts must be borne in mind. The act of 1864 did not differentiate, as do our modern laws, between a corporate income tax and an individual income tax. The act of 1864 taxed only a few classes of corporations, like certain financial and transportation companies. (For a list see Seligman, *The Income Tax*, p. 444.) In no other case was there corporate income

In C, the stock dividend we again have an appreciation of capital; but each share either (*a*) falls in value before December 31 or (*b*) remains at the old figure after that date. Since each shareholder, however, now owns more shares than he did, the net result is precisely as in the case of B, the increase of surplus. There is no separation of anything. There are indeed more paper certificates; but this does not change the essential nature of the transaction. There is no more separation of the assets than in B, the addition to surplus. There is no separation of the assets as in A, the cash dividend. The assets remain an undivided whole, whether they nominally consist of surplus or of any

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tax. The provision, declaring the profits of all corporations (except those specifically mentioned), to be a part of the income of the stockholder, was only a crude attempt to reach the corporate income and to prevent the evasion of the tax. Since that time, however, progress has been made in the theory of the income tax of the corporate or business tax. We now have in every country, including our own, a corporate income tax side by side with the individual income tax, There is therefore no justification for a continuance of the clumsy method of the Civil War tax. No country today thinks of characterizing as income the undivided share of the stockholder in the surplus of a corporation. The Hubbard case, therefore, has no application to present conditions, and from the economic point of view it was irrelevant for the government to cite it (Eisner *vs.* Macomber, *Brief for the United States*, p. 11).

The law of 1864 endeavored to tax the corporate income to th individual shareholder, because no attempt was made to tax it to the corporation. But under the present law the corporate income *is* taxed to the corporation, and there is accordingly no justification for taxing it to the individual. For a tax on undivided profits would then tax the same income twice. This, of course, does not mean that our present practice of levying, in addition to the corporate income tax, a separate tax on the stockholder when he actually realizes his own income is theoretically or practically indefensible. For in this case there are two separate incomes, one to the corporation and one to the individual. Whereas in the contemplation of the act of 1864 there was only one income—that of the corporation, taxable to the individual solely because it seemed inexpedient to tax it to the corporation.

other item. Nor is there any realization. The gain or capital increment is unrealized gain or inchoate income, precisely as in the case of B, the addition to surplus. There is no income to the shareholder, therefore, because there is neither realization nor separation.

It might be objected that in C, the stock dividend, the owner of 100 shares which previously were worth $10,000 may take his 50 new shares and sell them for $5,000, leaving his original capital of $10,000 unimpaired. This, as it might be said, puts the stock dividend, on a plane with A, the cash dividend. For the owner in the latter case will obviously sell his dividends for $5,000, leaving his original capital of $10,000 unimpaired.

It is a mistake, however, to think that this creates an analogy between C and A, that is, between the stock dividend and the cash dividend. For, in the case of B, the addition to surplus, the stockholder could have done precisely the same thing. That is, he could have taken 33 1/3 shares, sold them at $150, netted $5,000, and still have remaining his 66 2/3 shares worth, at $150, the sum of $10,000.

In this respect, then, there is no difference between A, B and C. If the stockholder cashes in his gains, all three cases are on a par. In none of these cases would there be any difference between income from capital and accretion to capital. For, when the gains are cashed in, the accretion to the capital is separated from the capital, leaving the capital unimpaired. Furthermore, if the stockholder sells all his stock, he will get in every case $15,000, and there will be in every case a gain or taxable income of $5,000. A capital gain cannot be realized without being separated; and when we have both separation and realization, capital increment has all the earmarks of income. If the stock-

holder sells his stock dividend the proceeds are undoubtedly income.

The question at issue, however, is entirely different: namely, what is the situation if the stockholder does *not* sell the stock? Here the real difference is between A, the cash dividend, on the one hand, and both B and C, the increase of surplus and the stock dividend, on the other.

In A, the cash dividend, the realized gain is income; in B, the increase in surplus, the unrealized gain is not income; in C, the stock dividend, the unrealized gain is not income.

Or, to put it in other words; A, the cash dividend, is indisputable income; B, the addition to surplus, is simply accretion to capital; C, the stock dividend, is equally nothing but accretion to capital. C then is like B and not like A; and in neither B nor C is the capital accretion income, because in neither case is the gain separated or realized. The stock dividend is like an increased surplus; it is not like a cash dividend. In fact, a stock dividend is not a dividend at all, in the sense in which a cash dividend is a dividend. The entire confusion really arises from a misnomer. For a dividend implies an actually realized increase of wealth; whereas, in a stock dividend there is no actually realized increase of wealth. As a matter of fact: in C, *a* (the stock dividend where the earnings have been slowly and openly accumulated) the stockholder is certainly no richer after December 31 than he was on December 30. And while in C, *b* (the stock dividend where the earnings have been unknown and unsuspected) the stockholder is in a certain sense richer on December 31 than on December 30, the gain is an unrealized increase of wealth, a mere paper increment. What is most important, above all, is that he is no

richer than he would have been if there had been no stock dividend at all but a simple distribution to surplus. The income tax, it must be remembered, is not a tax on every increase of wealth actual or imiginary; it is a tax only on income; and capital increment constitutes income, as we have seen, only when invested with the attributes of separation and realization.

A final objection might be raised as to the result of a fourth possibility in addition to the three alternatives mentioned on page 530. The directors of the corporation might decide to invest the $50,000 earnings in the securities of another corporation and then declare a dividend in kind. This is often done nowadays. But, if a distribution in "other stock" is income, it is triumphantly asked, why is a distribution of its own stock not likewise income? This objection has confused many thinkers. Yet the answer to the question is very simple. For in the one case there are both separation and realization; in the other, there is neither separation nor realization.

In the one case, the directors actually take the $50,000 and separate them from the assets. Whether they turn over to the stockholder the $50,000 in cash or buy commodities like copper and wool, or securities like stocks and bonds, and then turn them over to the stockholders is immaterial. In every case there is a separation of earnings from the assets and in every case the earnings when separated from the assets and turned over to the stockholder constitute his income. Whether the stockholder gets cash, or commodities in the shape of copper or wool, or the securities of the other corporation is immaterial to him. In every case he gets something which is the result of a separation from the principal. But if he gets a stock dividend, *i. e.*, the securities of own corporation, he does not

get anything which has been separated from the principal. He gets only an additional evidence of his share in the undivided and unseparated assets. In the one case there is separation; in the other there is no separation.

Nor can we say that the acquisition of a share of stock in another corporation is unrealized gain. On the contrary, it is realized in the true economic sense of the term. If, instead of a cash dividend, the stockholder receives some copper or wool, we should not say that it is unrealized gain, and that too, whether he keeps or sells the copper or wool. If, however, he receives instead of the copper or wool a share of stock in some other corporation, we should again not say the gain was unrealized and, that too, whether he keeps or sells the stock. For in every case where the acquisition is the result of a distinct separation of assets—a separation of earnings from the principal—there is realization; and where there is realization there is income. It is beside the point to claim that this share in a new corporation might fall in value before he sold it: The copper or wool might equally depreciate before he disposed of it; and the bank in which he deposited the cash dividend or the individual to whom he loaned the cash might equally well fail, so that he would possibly receive during the taxable year only a part of the original sum. The cash dividend is indisputably income even if the proceeds are subsequently lost. Whatever be the policy of the law toward deduction for losses, and irrespective of whether the taxpayer is permitted to count as a loss the mere depreciation of the copper or wool or "other stock," there can be no doubt that the gain (from which a deduction may or may not be permitted) is realized as soon as there is an acquisition of cash, of copper or wool, or of "other stock". Realiza-

tion does not mean immunity from loss. Realization occurs as soon as actual separation has been effected.

Thus in all these cases—cash dividend, copper or wool, and "other stock" there are both separation and realization: in a stock dividend there is neither separation nor realization. The gain from "other stock" is income; the gain from a stock dividend is not income.

The real distinction to be kept continually in mind in threading one's way through the mazes of the income tax is between the actual receipt of income on the one hand and the unrealized appreciation of capital on the other. A cash dividend is an example of the former; a stock dividend is an example of the latter. In the cash dividend, as in the "other stock," the gain is realized and separated; in the stock dividend, as in the addition to surplus, the gain is unrealized and unseparated. The first is income; the second is capital. A cash dividend is income; a stock dividend is not income

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EISNER, AS COLLECTOR OF UNITED STATES INTERNAL REVENUE FOR THE THIRD DISTRICT OF THE STATE OF NEW YORK, *v.* MACOMBER.

ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

No. 318. Argued April 16, 1919; restored to docket for reargument May 19, 1919; reargued October 17, 20, 1919.—Decided March 8, 1920.

Congress was not empowered by the Sixteenth Amendment to tax, as income of the stockholder, without apportionment, a stock dividend made lawfully and in good faith against profits accumulated by the corporation since March 1, 1913. P. 201. *Towne* v. *Eisner*, 245 U. S. 418.

The Revenue Act of September 8, 1916, c. 463, 39 Stat. 756, plainly evinces the purpose of Congress to impose such taxes and is to that extent in conflict with Art. I, § 2, cl. 3, and Art. 1, § 9, cl. 4, of the Constitution. Pp. 199, 217.

These provisions of the Constitution necessarily limit the extension, by construction, of the Sixteenth Amendment. P. 205.

What is or is not "income" within the meaning of the Amendment must be determined in each case according to truth and substance, without regard to form. P. 206.

Income may be defined as the gain derived from capital, from labor, or from both combined, including profit gained through sale or conversion of capital. P. 207.

Mere growth or increment of value in a capital investment is not income; income is essentially a gain or profit in itself of exchangeable value, proceeding from capital, severed from it, and derived or received by the taxpayer for his separate use, benefit and disposal. *Id.*

A stock dividend—evincing merely a transfer of an accumulated surplus to the capital account of the corporation—takes nothing from the property of the corporation and adds nothing to that of the shareholder; a tax on such dividends is a tax on capital increase and not on income, and to be valid under the Constitution such taxes must be apportioned according to population in the several States. P. 208.

Affirmed.

THE case is stated in the opinion.

Mr. Assistant Attorney General Frierson for plaintiff in error:

Stockholders have such an interest in the earnings and profits of a corporation that the same are within the power of Congress to tax as income even before they are divided. *Collector* v. *Hubbard*, 12 Wall. 1; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, 336; *Lynch* v. *Turrish*, 247 U. S. 221, 228; *Bailey* v. *Railroad Co.*, 22 Wall. 604, 635, 636; *Lynch* v. *Hornby*, 247 U. S. 339, 343.

The right of Congress to tax undivided profits cannot be destroyed by the issuance of stock certificates to represent them; and, since the certificates of stock in this case represent earnings of the corporation accrued subsequently to March 1, 1913, they are clearly made taxable as income by the Act of 1916, c. 463, 39 Stat. 756. *Peabody* v. *Eisner*, 247 U. S. 347; *Bailey* v. *Railroad Co.*, 22 Wall. 604, 635; *Swan Brewery Co., Ltd.*, v. *Rex*, [1914] A. C. 231, 234–236.

Towne v. *Eisner*, 245 U. S. 418, does not control this case. (1) It merely decides that the stock dividends then before the court, paid out of earnings accrued prior to March 1, 1913, were not income within the meaning of the Act of 1913. Nothing said in the opinion can be construed as challenging the power of Congress to tax, as the income of stockholders, the profits of a corporation even before they are divided, and much less to tax a certificate of stock issued to represent such profits. (2) The most that can be said of the opinion is that it holds that the term "dividend" in its ordinary acceptation does not include stock dividends, and that since the Act of 1913 used the term "dividend" without qualification stock dividends were not taxable under it. *Gibbons* v. *Mahon*, 136 U. S. 549, 559, 560. (3) The Act of 1916, however, expressly taxes stock dividends, and hence *Towne* v. *Eisner* is not controlling.

The case of *Lynch* v. *Hornby*, 247 U. S. 339, holding that cash dividends are to be treated as income for the year in which received, whether paid out of earnings accruing before or after March 1, 1913, in view of the reasons stated for the holding, would not have been inconsistent with a holding that stock dividends were taxable when representing earnings accruing after March 1, 1913, but not taxable when representing earnings accruing before that date.

But whether such holdings would have been inconsistent or not, the holding in *Lynch* v. *Hornby* is not controlling in this case, since the Act of 1916 makes it plain that dividends, whether paid in cash or stock, are to be taxed only when they represent earnings accruing after March 1, 1913.

While *Gibbons* v. *Mahon*, *supra*, holds that as between a life tenant and a remainderman stock dividends are not income, that case arose in the District of Columbia, involves no federal question, and is not controlling in similar cases arising in the state courts. As a matter of fact, most of the state courts have adopted a different ruling and hold that stock dividends are income. In the Act of 1916, therefore, Congress was clearly within its power when it declared that by "dividends" it meant either cash or stock dividends in accordance with the meaning of the term as understood and construed by the courts of most of the States. *Pritchitt* v. *Nashville Trust Co.*, 96 Tennessee, 472; *Thomas* v. *Gregg*, 78 Maryland, 545; *McLouth* v. *Hunt*, 154 N. Y. 179; *Will of Pabst*, 146 Wisconsin, 330; *Lord* v. *Brooks*, 52 N. H. 72; *Hite* v. *Hite*, 93 Kentucky, 257; *Moss's Appeal*, 83 Pa. St. 264; *Paris* v. *Paris*, 10 Ves. Jr. 184; *Tax Commissioner* v. *Putnam*, 227 Massachusetts, 522; *Matter of Osborne*, 209 N. Y. 450; *Goodwin* v. *McGaughey*, 108 Minnesota, 248.

The ultimate object of corporate business is gain to the stockholders. This gain always and necessarily first ap-

pears in the shape of undivided profits which are held in trust for them. When, later, dividends are declared, the cash or stock received by a stockholder is the same gain converted into a concrete form for the convenient payment, transfer, or definite assignment to him of his share of the previously undivided profits.

The Government is under no delusions as to the nature of a stock dividend, or as to what it accomplishes. It serves to readjust the evidence of ownership by which the stockholder previously held his share of both capital and undivided profits. His share of profits is invested for him in the stock of the company. The profits are segregated from his former capital and he has a separate certificate representing his invested profits or gains. It is, of course, conceded that this transaction does not, of itself, make the stockholder richer than he was before. The Government readily agrees that there has been a mere change in form of that which already belonged to the stockholder and that what was not income before is not income after a stock dividend. But this contention of defendant in error proves too much and destroys her case. Her share of undivided profits which has, by undergoing a mere change of form, become 198 shares of stock, was itself *income* within the power of Congress to tax. Unless its *change of form* destroyed its previous character it was still income. It is defendant in error and not the Government who must rely upon the change of form for success in this case. The Government claims the right to tax gains when wearing a new dress only when they were taxable in their old dress. The defendant in error's contention cannot succeed unless the new dress destroys the power to tax which existed before it was put on.

So far as what they serve to transfer or assign to stockholders is concerned, there are but two points of difference between cash dividends and stock dividends. By a cash dividend, a corporation transfers to a stockholder his

share of corporate earnings in money, while, in the case of a stock dividend, it first invests the earnings in its business and then issues to each stockholder new shares of stock of the same par value as his share of the earnings or, to use other words, invests each stockholder's share of the earnings in its own stock at par and delivers to him the stock so purchased. In either case, he simply gets, in a concrete form, the actual gains he has derived from his invested capital.

The other point of difference is that a cash dividend may serve either to distribute profits or return capital. A stock dividend, on the other hand, never contemplates a reduction in capital but, on the contrary, necessarily implies an increase in capital to be represented by the new shares. It can never, therefore, serve to return capital, but that which, in the form of new stock, it assigns to each stockholder, is always a share of corporate earnings or gains. In other words, a cash dividend may or may not distribute gains, but a stock dividend cannot, under any circumstances, distribute, assign, or transfer anything else.

If the constitutional power exists to tax corporate earnings when they are passed to the stockholder by means of a cash dividend, no reason is perceived why the same power does not exist to tax the same earnings when they are passed to him, in an equally concrete form, by means of a stock dividend.

Stock issued as a dividend is property in every sense that any other thing of value is property.

The Act of 1916 taxes gains derived from capital invested in corporate stocks, that is, shares of corporate gains or profits. It does not tax dividends *per se* but merely uses them to indicate the form in which such gains shall be taxed and to mark the time when the tax shall be collected. And, in the case of stock dividends, it uses the stock issued to measure the amount of the gains.

The substance of the Act of 1916 is that no corporate earnings are taxed as distributed gains which might not have been taxed as undivided profits when they accrued, and all such earnings which might have been taxed as undivided profits are taxed when distributed.

Before a dividend, one certificate is the evidence of a stockholder's ownership of a share of capital and also a share of profits. When he receives a cash dividend the value of his certificate is reduced and the money received measures the gain which his investment has yielded. When he receives a stock dividend, the par value of his new certificate measures his gains. As the fruit or result of his investment, something of value, which is distinct from his original capital and distinct from the corporation's ownership of its assets, has come to him.

The fact that a stockholder is no richer immediately after than immediately before a stock dividend is wholly unimportant. Neither is he made richer by a cash dividend.

The important fact is that, assuming the profits have been earned since March 1, 1913, he has, in either case, become richer since that date through the earnings of his invested capital. Congress has seen fit to say that these earnings may accumulate free from tax until they are delivered to him either as cash or in stock. His gain comes, not from the declaration of a dividend of any kind, but from what his capital has earned. The only effect of the dividend is to fix the date upon which, under the law, his share of corporate earnings, previously accrued, becomes taxable.

Mr. Charles E. Hughes, with whom *Mr. George Welwood Murray* was on the briefs, for defendant in error:

The tax in question is not laid with respect to the taxpayer's interest in undivided corporate profits as constituting income to the taxpayer, or upon the "stock dividend"

as the form or dress in which a previous gain or income to the taxpayer appears. The tax is laid upon the "stock dividend" as constituting income in itself.

Undivided corporate profits are not income to the stockholder. It is of the essence of income that it should be realized. Potentiality is not enough. Book entries or opinions of increase are not income. Income necessarily implies separation and realization. The increase of the forest is not income until it is cut. The increase in the value of lands due to the growth and prosperity of the community is not income until it is realized. Where investments are concerned, there is no income until there has been a separate, realized gain. When a corporation earns profits, it receives money over the amount of its expenditures. The money belongs to the corporation; the profits are the property of the corporation. If the corporation distributes its earnings in dividends, properly so-called, that is, in money, or in property *in specie*, the stockholder has realized a gain and that gain is income. The shareholder has simply his share, his interest, in the corporate enterprise. The corporation must, of course, pay its income tax upon its profits, but there is no income to the shareholder unless he receives it. His share interest is a "capital" interest.

This distinction is not a form or technicality. It is a vital distinction inherent in corporate organization. The interest of the shareholder is a distinct interest. The profits of the corporation are not his profits. This distinction between the title of a corporation and the interest of its shareholders in the property of the corporation, including its earnings, has been authoritatively established by two lines of decisions of this court in cases involving the power of taxation:

(1) *Van Allen* v. *The Assessors*, 3 Wall. 573, 584; *People* v. *Commissioners*, 4 Wall. 244; *Bradley* v. *People*, 4 Wall. 459; *National Bank* v. *Commonwealth*, 9 Wall. 353, 358,

359; *Owensboro National Bank* v. *Owensboro*, 173 U. S. 664, 680; *Evansville Bank* v. *Britton*, 105 U. S. 322; *Cleveland Trust Co.* v. *Lander*, 184 U. S. 111; *Home Savings Bank* v. *Des Moines*, 205 U. S. 503; *Rogers* v. *Hennepin County*, 240 U. S. 184.

(2) *Bank of Commerce* v. *Tennessee*, 161 U. S. 134, 146; *Shelby County* v. *Union & Planters' Bank*, 161 U. S. 149, 153–154; *Wright* v. *Georgia R. R. & Banking Co.*, 216 U. S. 420, 425; *Farrington* v. *Tennessee*, 95 U. S. 679; *Sturges* v. *Carter*, 114 U. S. 511; *Tennessee* v. *Whitworth*, 117 U. S. 129; *New Orleans* v. *Houston*, 119 U. S. 265; *New Orleans* v. *Citizens' Bank*, 167 U. S. 371; *Powers* v. *Detroit, Grand Haven &c. Ry. Co.*, 201 U. S. 543.

When the question of the nature of the shareholder's interest in undivided profits came before this court in *Gibbons* v. *Mahon*, 136 U. S. 549, the question was carefully considered and explicitly determined. The court pointed out the distinction between the money earned by the corporation and the shareholder's income, and ruled expressly that the interest of the shareholder in the accumulated earnings of the corporation, as a part of his share interest, was capital and not income, so long as the earnings were held and invested by the corporation as a part of its corporate property. See *Towne* v. *Eisner*, 245 U. S. 418.

The case of *Collector* v. *Hubbard*, 12 Wall. 1, arose under a provision that gains and profits of certain companies should be included in estimating the annual gains, profits or income of any person entitled to the same, whether divided or otherwise. The object was to insure the payment of the tax upon the earnings of the corporation (see *Gibbons* v. *Mahon*, 136 U. S. 549, 560). It was a crude method of reaching the corporate earnings and was the only tax imposed with respect to those earnings. A shareholder was to be taxed upon the increment supposed to have been added to the value of his share by his pro-

portionate interest in the undivided profits. This, as a matter of statutory construction, is clear enough. But it by no means follows that this increment was income to the shareholder, when it becomes necessary to distinguish between a tax on income and a direct tax on the capital investment.

The *Hubbard Case* was dealing with the mere fact of the increment and did not deal with its nature, as the court in the *Gibbons Case* was called upon to deal. The reason why the court in the *Hubbard Case* was not called upon to define the nature of the increment, beyond the fact that it was *property*, is apparent from the absence of any controversy over a constitutional question, and from the opinion entertained at the time with respect to what was a direct and what was an indirect tax under the Federal Constitution; accepting the view then entertained of direct and indirect taxes, the decision was unassailable.

It was not necessary for Mr. Justice Clifford, in the absence of the debate which about twenty-five years later took place in *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429; 158 U. S. 601, to go further. When, however, the court had occasion to deal with the precise question, in *Gibbons* v. *Mahon*, it stated its conclusion emphatically, and without the slightest reservation, that whatever increment there was, through undivided profits held and invested by the corporation, to the share of the stockholder, was capital and not income. But the increment in the *Hubbard Case* was nothing but an accretion to capital. It was not a separated, realized gain. It was not income. Hence, under the doctrine of the *Pollock Case* and the doctrine now applicable to all cases where a capital interest is taxed, the tax could not validly be laid except as an apportioned direct tax. [*Bailey* v. *Railroad Co.*, 22 Wall. 604, and recent cases cited by the Government, distinguished.]

Income is the gain, come to fruition, from capital, from labor, or from both combined. This is sound doctrine both in law and in economics. Income of a corporation is not income of a shareholder until distributed. A "stock dividend" is not income. It does not constitute a distribution of anything; it is a mere readjustment of capital. *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415; *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 185; *Lynch* v. *Hornby*, 247 U. S. 339, 343; *Lynch* v. *Turrish*, 247 U. S. 221, 231; *Commissioners of Inland Revenue* v. *Blott* [reported in the London Times of July 25, 1919]; Seligman, Income Tax, p. 19; "The Economic Nature of the Stock Dividend," by Fairchild, Bulletin of National Tax Assn., vol. III, No. 7, April, 1918, p. 163; Seligman, "Are Stock Dividends Income," American Economic Review, vol. IX, No. 3, p. 517; *Peabody* v. *Eisner*, 247 U. S. 347; *Towne* v. *Eisner*, 245 U. S. 418, 426; *Union Trust Co.* v. *Coleman*, 126 N. Y. 433, 438.

The tax in question is an income tax and cannot be sustained as anything else.

Mr. George W. Wickersham and *Mr. Charles Robinson Smith*, by leave of court, filed a brief as *amici curiæ:*

The principle laid down by this court in two well-considered cases (*Gibbons* v. *Mahon*, 136 U. S. 549, and *Towne* v. *Eisner*, 245 U. S. 418), that stock dividends represent capital and do not constitute income is based on sound economic reasoning.

Although *Collector* v. *Hubbard*, 12 Wall. 1, is plainly distinguishable from the case at bar, it is inconsistent both with other and later rulings of this court and with sound economics. It tends to block the way to a consistent, harmonious and logical system of income taxation and it should be expressly overruled. As upholding a tax on property except by apportionment under Art. I, § 2, of the Constitution, it has been overruled by *Pollock* v. *Farmers'*

Loan & Trust Co., 157 U. S. 429; 158 U. S. 601. In so far as it assumes an equivalency between the property and the income of the corporation and the shares of stock in the names of the stockholders for taxation purposes, it has been implicitly overruled by a long series of authorities in this court. The suggestion that this court has in other cases cited *Collector* v. *Hubbard* or its principle with approval except upon altogether minor points is erroneous.

The stock dividend is in reality not a dividend at all. It is a mere certified expression of an undivided surplus and its capitalization. Whatsoever gain there may be in either case to the stockholder is a capital gain. Capital gains (being mere increases in valuation) are not income until realized. The gains that come with stock dividends when stock is sold are realized capital gains—the same in nature and similarly taxable as those gains that are made with any stock that is sold at an advance. Inasmuch as undivided corporate earnings cannot be taxed as income against the stockholder—so the stock certificates issued merely to represent these may not be so taxed, until the gain be realized in some form by sale.

MR. JUSTICE PITNEY delivered the opinion of the court.

This case presents the question whether, by virtue of the Sixteenth Amendment, Congress has the power to tax, as income of the stockholder and without apportionment, a stock dividend made lawfully and in good faith against profits accumulated by the corporation since March 1, 1913.

It arises under the Revenue Act of September 8, 1916, c. 463, 39 Stat. 756, *et seq.*, which, in our opinion (notwithstanding a contention of the Government that will be

noticed), plainly evinces the purpose of Congress to tax stock dividends as income.[1]

The facts, in outline, are as follows:

On January 1, 1916, the Standard Oil Company of California, a corporation of that State, out of an authorized capital stock of $100,000,000, had shares of stock outstanding, par value $100 each, amounting in round figures to $50,000,000. In addition, it had surplus and undivided profits invested in plant, property, and business and required for the purposes of the corporation, amounting to about $45,000,000, of which about $20,000,000 had been earned prior to March 1, 1913, the balance thereafter. In January, 1916, in order to readjust the capitalization, the board of directors decided to issue additional shares sufficient to constitute a stock dividend of 50 per cent. of the outstanding stock, and to transfer from surplus account to capital stock account an amount equivalent to such issue. Appropriate resolutions were adopted, an amount equivalent to the par value of the proposed new stock was transferred accordingly, and the new stock duly issued against it and divided among the stockholders.

Defendant in error, being the owner of 2,200 shares of the old stock, received certificates for 1,100 additional

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[1] TITLE I.—INCOME TAX.

PART I.—ON INDIVIDUALS.

Sec. 2 (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived . . . , also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: *Provided*, That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, . . . out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, . . . which stock dividend shall be considered income, to the amount of its cash value.

shares, of which 18.07 per cent., or 198.77 shares, par value $19,877, were treated as representing surplus earned between March 1, 1913, and January 1, 1916. She was called upon to pay, and did pay under protest, a tax imposed under the Revenue Act of 1916, based upon a supposed income of $19,877 because of the new shares; and an appeal to the Commissioner of Internal Revenue having been disallowed, she brought action against the Collector to recover the tax. In her complaint she alleged the above facts, and contended that in imposing such a tax the Revenue Act of 1916 violated Art. I, § 2, cl. 3, and Art. I, § 9, cl. 4, of the Constitution of the United States, requiring direct taxes to be apportioned according to population, and that the stock dividend was not income within the meaning of the Sixteenth Amendment. A general demurrer to the complaint was overruled upon the authority of *Towne* v. *Eisner*, 245 U. S. 418; and, defendant having failed to plead further, final judgment went against him. To review it, the present writ of error is prosecuted.

The case was argued at the last term, and reargued at the present term, both orally and by additional briefs.

We are constrained to hold that the judgment of the District Court must be affirmed: First, because the question at issue is controlled by *Towne* v. *Eisner*, *supra;* secondly, because a reëxamination of the question, with the additional light thrown upon it by elaborate arguments, has confirmed the view that the underlying ground of that decision is sound, that it disposes of the question here presented, and that other fundamental considerations lead to the same result.

In *Towne* v. *Eisner*, the question was whether a stock dividend made in 1914 against surplus earned prior to January 1, 1913, was taxable against the stockholder under the Act of October 3, 1913, c. 16, 38 Stat. 114, 166, which provided (§ B, p. 167) that net income should include "dividends," and also "gains or profits and income de-

rived from any source whatever." Suit having been brought by a stockholder to recover the tax assessed against him by reason of the dividend, the District Court sustained a demurrer to the complaint. 242 Fed. Rep. 702. The court treated the construction of the act as inseparable from the interpretation of the Sixteenth Amendment; and, having referred to *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, and quoted the Amendment, proceeded very properly to say (p. 704): "It is manifest that the stock dividend in question cannot be reached by the Income Tax Act, and could not, even though Congress expressly declared it to be taxable as income, unless it is in fact income." It declined, however, to accede to the contention that in *Gibbons* v. *Mahon*, 136 U. S. 549, "stock dividends" had received a definition sufficiently clear to be controlling, treated the language of this court in that case as *obiter dictum* in respect of the matter then before it (p. 706), and examined the question as *res nova*, with the result stated. When the case came here, after overruling a motion to dismiss made by the Government upon the ground that the only question involved was the construction of the statute and not its constitutionality, we dealt upon the merits with the question of construction only, but disposed of it upon consideration of the essential nature of a stock dividend, disregarding the fact that the one in question was based upon surplus earnings that accrued before the Sixteenth Amendment took effect. Not only so, but we rejected the reasoning of the District Court, saying (245 U. S. 426): "Notwithstanding the thoughtful discussion that the case received below we cannot doubt that the dividend was capital as well for the purposes of the Income Tax Law as for distribution between tenant for life and remainderman. What was said by this court upon the latter question is equally true for the former. 'A stock dividend really takes nothing from the property of the corporation, and adds nothing to the

interests of the shareholders. Its property is not diminished, and their interests are not increased. . . . The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones.' *Gibbons* v. *Mahon*, 136 U. S. 549, 559, 560. In short, the corporation is no poorer and the stockholder is no richer than they were before. *Logan County* v. *United States*, 169 U. S. 255, 261. If the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417,450, the sum upon which he was taxed. . . . What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new."

This language aptly answered not only the reasoning of the District Court but the argument of the Solicitor General in this court, which discussed the essential nature of a stock dividend. And if, for the reasons thus expressed, such a dividend is not to be regarded as "income" or "dividends" within the meaning of the Act of 1913, we are unable to see how it can be brought within the meaning of "incomes" in the Sixteenth Amendment; it being very clear that Congress intended in that act to exert its power to the extent permitted by the Amendment. In *Towne* v. *Eisner* it was not contended that any construction of the statute could make it narrower than the constitutional grant; rather the contrary.

The fact that the dividend was charged against profits earned before the Act of 1913 took effect, even before the Amendment was adopted, was neither relied upon nor alluded to in our consideration of the merits in that case. Not only so, but had we considered that a stock dividend constituted income in any true sense, it would have been held taxable under the Act of 1913 notwithstanding it was

based upon profits earned before the Amendment. We ruled at the same term, in *Lynch* v. *Hornby*, 247 U. S. 339, that a cash dividend extraordinary in amount, and in *Peabody* v. *Eisner*, 247 U. S. 347, that a dividend paid in stock of another company, were taxable as income although based upon earnings that accrued before adoption of the Amendment. In the former case, concerning "corporate profits that accumulated before the Act took effect," we declared (pp. 343–344): "Just as we deem the legislative intent manifest to tax the stockholder with respect to such accumulations only if and when, and to the extent that, his interest in them comes to fruition as income, that is, in dividends declared, so we can perceive no constitutional obstacle that stands in the way of carrying out this intent when dividends are declared out of a pre-existing surplus. . . . Congress was at liberty under the Amendment to tax as income, without apportionment, everything that became income, in the ordinary sense of the word, after the adoption of the Amendment, including dividends received in the ordinary course by a stockholder from a corporation, even though they were extraordinary in amount and might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing." In *Peabody* v. *Eisner* (pp. 349–350), we observed that the decision of the District Court in *Towne* v. *Eisner* had been reversed "only upon the ground that it related to a stock dividend which in fact took nothing from the property of the corporation and added nothing to the interest of the shareholder, but merely changed the evidence which represented that interest;" and we distinguished the *Peabody Case* from the *Towne Case* upon the ground that "the dividend of Baltimore & Ohio shares was not a stock dividend but a distribution *in specie* of a portion of the assets of the Union Pacific."

Therefore, *Towne* v. *Eisner* cannot be regarded as turn-

ing upon the point that the surplus accrued to the company before the act took effect and before adoption of the Amendment. And what we have quoted from the opinion in that case cannot be regarded as *obiter dictum*, it having furnished the entire basis for the conclusion reached. We adhere to the view then expressed, and might rest the present case there; not because that case in terms decided the constitutional question, for it did not; but because the conclusion there reached as to the essential nature of a stock dividend necessarily prevents its being regarded as income in any true sense.

Nevertheless, in view of the importance of the matter, and the fact that Congress in the Revenue Act of 1916 declared (39 Stat. 757) that a "stock dividend shall be considered income, to the amount of its cash value," we will deal at length with the constitutional question, incidentally testing the soundness of our previous conclusion.

The Sixteenth Amendment must be construed in connection with the taxing clauses of the original Constitution and the effect attributed to them before the Amendment was adopted. In *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, under the Act of August 27, 1894, c. 349, § 27, 28 Stat. 509, 553, it was held that taxes upon rents and profits of real estate and upon returns from investments of personal property were in effect direct taxes upon the property from which such income arose, imposed by reason of ownership; and that Congress could not impose such taxes without apportioning them among the States according to population, as required by Art. I, § 2, cl. 3, and § 9, cl. 4, of the original Constitution.

Afterwards, and evidently in recognition of the limitation upon the taxing power of Congress thus determined, the Sixteenth Amendment was adopted, in words lucidly expressing the object to be accomplished: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among

the several States, and without regard to any census or enumeration." As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the States of taxes laid on income. *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, 17–19; *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, 112 *et seq.*; *Peck & Co.* v. *Lowe*, 247 U. S. 165, 172–173.

A proper regard for its genesis, as well as its very clear language, requires also that this Amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts.

In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not "income," as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised.

The fundamental relation of "capital" to "income" has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term "in-

come," as used in common speech, in order to determine its meaning in the Amendment; and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue.

After examining dictionaries in common use (Bouv. L. D.; Standard Dict.; Webster's Internat. Dict.; Century Dict.), we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 (*Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415; *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 185)—"Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle Case* (pp. 183, 185).

Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word "gain," which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. "*Derived—from—capital*";—"the *gain—derived—from—capital*," etc. Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being "*derived*," that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description.

The same fundamental conception is clearly set forth in the Sixteenth Amendment—"incomes, *from* whatever *source derived*"—the essential thought being expressed

with a conciseness and lucidity entirely in harmony with the form and style of the Constitution.

Can a stock dividend, considering its essential character, be brought within the definition? To answer this, regard must be had to the nature of a corporation and the stockholder's relation to it. We refer, of course, to a corporation such as the one in the case at bar, organized for profit, and having a capital stock divided into shares to which a nominal or par value is attributed.

Certainly the interest of the stockholder is a capital interest, and his certificates of stock are but the evidence of it. They state the number of shares to which he is entitled and indicate their par value and how the stock may be transferred. They show that he or his assignors, immediate or remote, have contributed capital to the enterprise, that he is entitled to a corresponding interest proportionate to the whole, entitled to have the property and business of the company devoted during the corporate existence to attainment of the common objects, entitled to vote at stockholders' meetings, to receive dividends out of the corporation's profits if and when declared, and, in the event of liquidation, to receive a proportionate share of the net assets, if any, remaining after paying creditors. Short of liquidation, or until dividend declared, he has no right to withdraw any part of either capital or profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it the interest of an owner in the assets themselves, since the corporation has full title, legal and equitable, to the whole. The stockholder has the right to have the assets employed in the enterprise, with the incidental rights mentioned; but, as stockholder, he has no right to withdraw, only the right to persist, subject to the risks of the enterprise, and looking only to dividends for his return. If he desires to dissociate himself

from the company he can do so only by disposing of his stock.

For bookkeeping purposes, the company acknowledges a liability in form to the stockholders equivalent to the aggregate par value of their stock, evidenced by a "capital stock account." If profits have been made and not divided they create additional bookkeeping liabilities under the head of "profit and loss," "undivided profits," "surplus account," or the like. None of these, however, gives to the stockholders as a body, much less to any one of them, either a claim against the going concern for any particular sum of money, or a right to any particular portion of the assets or any share in them unless or until the directors conclude that dividends shall be made and a part of the company's assets segregated from the common fund for the purpose. The dividend normally is payable in money, under exceptional circumstances in some other divisible property; and when so paid, then only (excluding, of course, a possible advantageous sale of his stock or winding-up of the company) does the stockholder realize a profit or gain which becomes his separate property, and thus derive income from the capital that he or his predecessor has invested.

In the present case, the corporation had surplus and undivided profits invested in plant, property, and business, and required for the purposes of the corporation, amounting to about $45,000,000, in addition to outstanding capital stock of $50,000,000. In this the case is not extraordinary. The profits of a corporation, as they appear upon the balance sheet at the end of the year, need not be in the form of money on hand in excess of what is required to meet current liabilities and finance current operations of the company. Often, especially in a growing business, only a part, sometimes a small part, of the year's profits is in property capable of division; the remainder having been absorbed in the acquisition of increased plant,

equipment, stock in trade, or accounts receivable, or in decrease of outstanding liabilities. When only a part is available for dividends, the balance of the year's profits is carried to the credit of undivided profits, or surplus, or some other account having like significance. If thereafter the company finds itself in funds beyond current needs it may declare dividends out of such surplus or undivided profits; otherwise it may go on for years conducting a successful business, but requiring more and more working capital because of the extension of its operations, and therefore unable to declare dividends approximating the amount of its profits. Thus the surplus may increase until it equals or even exceeds the par value of the outstanding capital stock. This may be adjusted upon the books in the mode adopted in the case at bar—by declaring a "stock dividend." This, however, is no more than a book adjustment, in essence not a dividend but rather the opposite; no part of the assets of the company is separated from the common fund, nothing distributed except paper certificates that evidence an antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company, but profits so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution. In order to make the adjustment, a charge is made against surplus account with corresponding credit to capital stock account, equal to the proposed "dividend"; the new stock is issued against this and the certificates delivered to the existing stockholders in proportion to their previous holdings. This, however, is merely bookkeeping that does not affect the aggregate assets of the corporation or its outstanding liabilities; it affects only the form, not the essence, of the "liability" acknowledged by the corporation to its own shareholders, and this through a readjustment of accounts on one side of the balance sheet only, increasing "capital stock" at the expense of

"surplus"; it does not alter the preëxisting proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of the shares, with consequent dilution of the value of each share.

A "stock dividend" shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.

The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment.

Being concerned only with the true character and effect of such a dividend when lawfully made, we lay aside the question whether in a particular case a stock dividend may be authorized by the local law governing the corporation, or whether the capitalization of profits may be the result of correct judgment and proper business policy on the part of its management, and a due regard for the interests of the stockholders. And we are considering the taxability of *bona fide* stock dividends only.

We are clear that not only does a stock dividend really take nothing from the property of the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction.

It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit. But if a shareholder sells dividend stock he necessarily disposes of a part of his capital interest, just as if he should sell a part of his old stock, either before or after the dividend. What he retains no longer entitles him to the same proportion of future dividends as before the sale. His part in the control of the company likewise is diminished. Thus, if one holding $60,000 out of a total $100,000 of the capital stock of a corporation should receive in common with other stockholders a 50 per cent. stock dividend, and should sell his part, he thereby would be reduced from a majority to a minority stockholder, having six-fifteenths instead of six-tenths of the total stock outstanding. A corresponding and proportionate decrease in capital interest and in voting power would befall a minority holder should he sell dividend stock; it being in the nature of things impossible for one to dispose of any part of such an issue without a proportionate disturbance of the distribution of the entire capital stock, and a like diminution of the seller's comparative voting power—that "right preservative of rights" in the control of a corporation.

Yet, without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax.

Throughout the argument of the Government, in a variety of forms, runs the fundamental error already mentioned—a failure to appraise correctly the force of the term "income" as used in the Sixteenth Amendment, or at least to give practical effect to it. Thus, the Government contends that the tax "is levied on income derived from corporate earnings," when in truth the stockholder has "derived" nothing except paper certificates which, so far as they have any effect, deny him present participation in such earnings. It contends that the tax may be laid when earnings "are received by the stockholder," whereas he has received none; that the profits are "distributed by means of a stock dividend," although a stock dividend distributes no profits; that under the Act of 1916 "the tax is on the stockholder's share in corporate earnings," when in truth a stockholder has no such share, and receives none in a stock dividend; that "the profits are segregated from his former capital, and he has a separate certificate representing his invested profits or gains," whereas there has been no segregation of profits, nor has he any separate certificate representing a personal gain, since the certificates, new and old, are alike in what they represent—a capital interest in the entire concerns of the corporation.

We have no doubt of the power or duty of the court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable by Congress without apportionment. But, looking through the form,

we cannot disregard the essential truth disclosed; ignore the substantial difference between corporation and stockholder; treat the entire organization as unreal; look upon stockholders as partners, when they are not such; treat them as having in equity a right to a partition of the corporate assets, when they have none; and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend—even one paid in money or property—can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even when divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.

Conceding that the mere issue of a stock dividend makes the recipient no richer than before, the Government nevertheless contends that the new certificates measure the extent to which the gains accumulated by the corporation have made him the richer. There are two insuperable difficulties with this: In the first place, it would depend upon how long he had held the stock whether the stock dividend indicated the extent to which he had been enriched by the operations of the company; unless he had held it throughout such operations the measure would not hold true. Secondly, and more important for present purposes, enrichment through increase in value

of capital investment is not income in any proper meaning of the term.

The complaint contains averments respecting the market prices of stock such as plaintiff held, based upon sales before and after the stock dividend, tending to show that the receipt of the additional shares did not substantially change the market value of her entire holdings. This tends to show that in this instance market quotations reflected intrinsic values—a thing they do not always do. But we regard the market prices of the securities as an unsafe criterion in an inquiry such as the present, when the question must be, not what will the thing sell for, but what is it in truth and in essence.

It is said there is no difference in principle between a simple stock dividend and a case where stockholders use money received as cash dividends to purchase additional stock contemporaneously issued by the corporation. But an actual cash dividend, with a real option to the stockholder either to keep the money for his own or to reinvest it in new shares, would be as far removed as possible from a true stock dividend, such as the one we have under consideration, where nothing of value is taken from the company's assets and transferred to the individual ownership of the several stockholders and thereby subjected to their disposal.

The Government's reliance upon the supposed analogy between a dividend of the corporation's own shares and one made by distributing shares owned by it in the stock of another company, calls for no comment beyond the statement that the latter distributes assets of the company among the shareholders while the former does not; and for no citation of authority except *Peabody* v. *Eisner*, 247 U. S. 347, 349–350.

Two recent decisions, proceeding from courts of high jurisdiction, are cited in support of the position of the Government.

Swan Brewery Co., Ltd., v. *Rex*, [1914] A. C. 231, arose under the Dividend Duties Act of Western Australia, which provided that "dividend" should include "every dividend, profit, advantage, or gain intended to be paid or credited to or distributed among any members or directors of any company," except, etc. There was a stock dividend, the new shares being allotted among the shareholders *pro rata;* and the question was whether this was a distribution of a dividend within the meaning of the act. The Judicial Committee of the Privy Council sustained the dividend duty upon the ground that, although "in ordinary language the new shares would not be called a dividend, nor would the allotment of them be a distribution of a dividend," yet, within the meaning of the act, such new shares were an "advantage" to the recipients. There being no constitutional restriction upon the action of the lawmaking body, the case presented merely a question of statutory construction, and manifestly the decision is not a precedent for the guidance of this court when acting under a duty to test an act of Congress by the limitations of a written Constitution having superior force.

In *Tax Commissioner* v. *Putnam* (1917), 227 Massachusetts, 522, it was held that the 44th Amendment to the constitution of Massachusetts, which conferred upon the legislature full power to tax incomes, "must be interpreted as including every item which by any reasonable understanding can fairly be regarded as income" (pp. 526, 531); and that under it a stock dividend was taxable as income, the court saying (p. 535): "In essence the thing which has been done is to distribute a symbol representing an accumulation of profits, which instead of being paid out in cash is invested in the business, thus augmenting its durable assets. In this aspect of the case the substance of the transaction is no different from what it would be if a cash dividend had been declared with the privilege of subscription to an equivalent amount of new shares."

We cannot accept this reasoning. Evidently, in order to give a sufficiently broad sweep to the new taxing provision, it was deemed necessary to take the symbol for the substance, accumulation for distribution, capital accretion for its opposite; while a case where money is paid into the hand of the stockholder with an option to buy new shares with it, followed by acceptance of the option, was regarded as identical in substance with a case where the stockholder receives no money and has no option. The Massachusetts court was not under an obligation, like the one which binds us, of applying a constitutional amendment in the light of other constitutional provisions that stand in the way of extending it by construction.

Upon the second argument, the Government, recognizing the force of the decision in *Towne* v. *Eisner*, *supra*, and virtually abandoning the contention that a stock dividend increases the interest of the stockholder or otherwise enriches him, insisted as an alternative that by the true construction of the Act of 1916 the tax is imposed not upon the stock dividend but rather upon the stockholder's share of the undivided profits previously accumulated by the corporation; the tax being levied as a matter of convenience at the time such profits become manifest through the stock dividend. If so construed, would the act be constitutional?

That Congress has power to tax shareholders upon their property interests in the stock of corporations is beyond question; and that such interests might be valued in view of the condition of the company, including its accumulated and undivided profits, is equally clear. But that this would be taxation of property because of ownership, and hence would require apportionment under the provisions of the Constitution, is settled beyond peradventure by previous decisions of this court.

The Government relies upon *Collector* v. *Hubbard* (1870),

12 Wall. 1, 17, which arose under § 117 of the Act of June 30, 1864, c. 173, 13 Stat. 223, 282, providing that "the gains and profits of all companies, whether incorporated or partnership, other than the companies specified in this section, shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise." The court held an individual taxable upon his proportion of the earnings of a corporation although not declared as dividends and although invested in assets not in their nature divisible. Conceding that the stockholder for certain purposes had no title prior to dividend declared, the court nevertheless said (p. 18): "Grant all that, still it is true that the owner of a share of stock in a corporation holds the share with all its incidents, and that among those incidents is the right to receive all future dividends, that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a member of the corporation until a dividend is made. Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift, or devise. Undivided profits invested in real estate, machinery, or raw material for the purpose of being manufactured are investments in which the stockholders are interested, and when such profits are actually appropriated to the payment of the debts of the corporation they serve to increase the market value of the shares, whether held by the original subscribers or by assignees." In so far as this seems to uphold the right of Congress to tax without apportionment a stockholder's interest in accumulated earnings prior to dividend declared, it must be regarded as overruled by *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 627, 628, 637. Conceding *Collector* v. *Hubbard* was inconsistent with the doctrine of that case, because it sustained a direct tax upon property not apportioned

among the States, the Government nevertheless insists that the Sixteenth Amendment removed this obstacle, so that now the *Hubbard Case* is authority for the power of Congress to levy a tax on the stockholder's share in the accumulated profits of the corporation even before division by the declaration of a dividend of any kind. Manifestly this argument must be rejected, since the Amendment applies to income only, and what is called the stockholder's share in the accumulated profits of the company is capital, not income. As we have pointed out, a stockholder has no individual share in accumulated profits, nor in any particular part of the assets of the corporation, prior to dividend declared.

Thus, from every point of view, we are brought irresistibly to the conclusion that neither under the Sixteenth Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder. The Revenue Act of 1916, in so far as it imposes a tax upon the stockholder because of such dividend, contravenes the provisions of Article I, § 2, cl. 3, and Article I, § 9, cl. 4, of the Constitution, and to this extent is invalid notwithstanding the Sixteenth Amendment.

Judgment affirmed.

MR. JUSTICE HOLMES, dissenting.

I think that *Towne* v. *Eisner*, 245 U. S. 418, was right in its reasoning and result and that on sound principles the stock dividend was not income. But it was clearly intimated in that case that the construction of the statute then before the Court might be different from that of the Constitution. 245 U. S. 425. I think that the word "incomes" in the Sixteenth Amendment should be read in

"a sense most obvious to the common understanding at the time of its adoption." *Bishop* v. *State*, 149 Indiana, 223, 230; *State* v. *Butler*, 70 Florida, 102, 133. For it was for public adoption that it was proposed. *McCulloch* v. *Maryland*, 4 Wheat. 316, 407. The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest. I am of opinion that the Amendment justifies the tax. See *Tax Commissioner* v. *Putnam*, 227 Massachusetts, 522, 532, 533.

MR. JUSTICE DAY concurs in this opinion.

MR. JUSTICE BRANDEIS, dissenting, delivered the following opinion, in which MR. JUSTICE CLARKE concurred.

Financiers, with the aid of lawyers, devised long ago two different methods by which a corporation can, without increasing its indebtedness, keep for corporate purposes accumulated profits, and yet, in effect, distribute these profits among its stockholders. One method is a simple one. The capital stock is increased; the new stock is paid up with the accumulated profits; and the new shares of paid-up stock are then distributed among the stockholders *pro rata* as a dividend. If the stockholder prefers ready money to increasing his holding of the stock in the company, he sells the new stock received as a dividend. The other method is slightly more complicated. Arrangements are made for an increase of stock to be offered to stockholders *pro rata* at par and, at the same time, for the payment of a cash dividend equal to the amount which the stockholder will be required to pay to

the company, if he avails himself of the right to subscribe for his *pro rata* of the new stock. If the stockholder takes the new stock, as is expected, he may endorse the dividend check received to the corporation and thus pay for the new stock. In order to ensure that all the new stock so offered will be taken, the price at which it is offered is fixed far below what it is believed will be its market value. If the stockholder prefers ready money to an increase of his holdings of stock, he may sell his right to take new stock *pro rata*, which is evidenced by an assignable instrument. In that event the purchaser of the rights repays to the corporation, as the subscription price of the new stock, an amount equal to that which it had paid as a cash dividend to the stockholder.

Both of these methods of retaining accumulated profits while in effect distributing them as a dividend had been in common use in the United States for many years prior to the adoption of the Sixteenth Amendment. They were recognized equivalents. Whether a particular corporation employed one or the other method was determined sometimes by requirements of the law under which the corporation was organized; sometimes it was determined by preferences of the individual officials of the corporation; and sometimes by stock market conditions. Whichever method was employed the resultant distribution of the new stock was commonly referred to as a stock dividend. How these two methods have been employed may be illustrated by the action in this respect (as reported in Moodys Manual, 1918 Industrial, and the Commercial and Financial Chronicle), of some of the Standard Oil companies, since the disintegration pursuant to the decision of this court in 1911. *Standard Oil Co.* v. *United States*, 221 U. S. 1.

(a) Standard Oil Co. (of Indiana), an Indiana corporation. It had on December 31, 1911, $1,000,000 capital stock (all common), and a large surplus. On May 15,

1912, it increased its capital stock to $30,000,000, and paid a simple stock dividend of 2900 per cent. in stock.[1]

(b) Standard Oil Co. (of Nebraska), a Nebraska corporation. If had on December 31, 1911, $600,000 capital stock (all common), and a substantial surplus. On April 15, 1912, it paid a simple stock dividend of 33 1/3 per cent., increasing the outstanding capital to $800,000. During the calendar year 1912 it paid cash dividends aggregating 20 per cent.; but it earned considerably more, and had at the close of the year again a substantial surplus. On June 20, 1913, it declared a further stock dividend of 25 per cent., thus increasing the capital to $1,000,000.[2]

(c) The Standard Oil Co. (of Kentucky), a Kentucky corporation. It had on December 31, 1913, $1,000,000 capital stock (all common), and $3,701,710 surplus. Of this surplus $902,457 had been earned during the calendar year 1913, the net profits of that year having been $1,002,-457 and the dividends paid only $100,000 (10 per cent.). On December 22, 1913, a cash dividend of $200 per share was declared payable on February 14, 1914, to stockholders of record January 31, 1914; and these stockholders were offered the right to subscribe for an equal amount of new stock at par and to apply the cash dividend in payment therefor. The outstanding stock was thus increased to $3,000,000. During the calendar years 1914, 1915 and 1916, quarterly dividends were paid on this stock at an annual rate of between 15 per cent. and 20 per cent., but the company's surplus increased by $2,347,614, so that on December 31, 1916, it had a large surplus over its $3,000,000 capital stock. On December 15, 1916, the company issued a circular to the stockholders, saying:

"The company's business for this year has shown a

[1] Moodys, p. 1544; Commercial and Financial Chronicle, Vol. 94, p. 831; Vol. 98, pp. 1005, 1076.

[2] Moodys, p. 1548; Commercial and Financial Chronicle, Vol. 94, p. 771; Vol. 96, p. 1428; Vol. 97, p. 1434; Vol. 98, p. 1541.

very good increase in volume and a proportionate increase in profits, and it is estimated that by Jan. 1, 1917, the company will have a surplus of over $4,000,000. The board feels justified in stating that if the proposition to increase the capital stock is acted on favorably, it will be proper in the near future to declare a cash dividend of 100%; and to allow the stockholders the privilege *pro rata* according to their holdings, to purchase the new stock at par, the plan being to allow the stockholders, if they desire, to use their cash dividend to pay for the new stock."

The increase of stock was voted. The company then paid a cash dividend of 100 per cent., payable May 1, 1917, again offering to such stockholders the right to subscribe for an equal amount of new stock at par and to apply the cash dividend in payment therefor.

Moodys Manual, describing the transaction with exactness, says first that the stock was increased from $3,000,000 to $6,000,000, "a cash dividend of 100%, payable May 1, 1917, being exchanged for one share of new stock, the equivalent of a 100% stock dividend." But later in the report giving, as customary in the Manual, the dividend record of the company, the Manual says: "A stock dividend of 200% was paid Feb. 14, 1914, and one of 100% on May 1, 1917." And in reporting specifically the income account of the company for a series of years ending December 31, covering net profits, dividends paid and surplus for the year, it gives, as the aggregate of dividends for the year 1917, $660,000; (which was the aggregate paid on the quarterly cash dividend—5 per cent. January and April; 6 per cent. July and October); and adds in a note: "In addition a stock dividend of 100% was paid during the year." [1] The Wall Street Journal of

[1] Moodys, p. 1547; Commercial and Financial Chronicle, Vol. 97, pp. 1589, 1827, 1903; Vol. 98, pp. 76, 457; Vol. 103, p. 2348. Poor's Manual of Industrials (1918), p. 2240, in giving the "Comparative

May 2, 1917, p. 2, quotes the 1917 "High" price for Standard Oil of Kentucky as "375 Ex. Stock Dividend."

It thus appears that among financiers and investors the distribution of the stock by whichever method effected is called a stock dividend; that the two methods by which accumulated profits are legally retained for corporate purposes and at the same time distributed as dividends are recognized by them to be equivalents; and that the financial results to the corporation and to the stockholders of the two methods are substantially the same—unless a difference results from the application of the federal income tax law.

Mrs. Macomber, a citizen and resident of New York, was, in the year 1916, a stockholder in the Standard Oil Company (of California), a corporation organized under the laws of California and having its principal place of business in that State. During that year she received from the company a stock dividend representing profits earned since March 1, 1913. The dividend was paid by direct issue of the stock to her according to the simple method described above, pursued also by the Indiana and Nebraska companies. In 1917 she was taxed under the federal law on the stock dividend so received at its par value of $100 a share, as income received during the year 1916. Such a stock dividend is income as distinguished from capital both under the law of New York and under the law of California; because in both States every dividend representing profits is deemed to be income whether paid in cash or in stock. It had been so held in New York, where the question arose as between life-tenant and remainderman, *Lowry* v. *Farmers' Loan & Trust Co.*, 172 N. Y. 137; *Matter of Osborne*, 209 N. Y. 450; and also, where the question arose in matters of taxation. *People* v. *Glynn*,

Income Account" of the company describes the 1914 dividend as "Stock Dividend paid (200%)—$2,000,000"; and describes the 1917 dividend as "$3,000,000 special cash dividend."

130 App. Div. 332; 198 N. Y. 605. It has been so held in California, where the question appears to have arisen only in controversies between life-tenant and remainderman. *Estate of Duffill*, 58 Cal. Dec. 97; 180 California, 748.

It is conceded that if the stock dividend paid to Mrs. Macomber had been made by the more complicated method pursued by the Standard Oil Company of Kentucky, that is, issuing rights to take new stock *pro rata* and paying to each stockholder simultaneously a dividend in cash sufficient in amount to enable him to pay for this *pro rata* of new stock to be purchased—the dividend so paid to him would have been taxable as income, whether he retained the cash or whether he returned it to the corporation in payment for his *pro rata* of new stock. But it is contended that, because the simple method was adopted of having the new stock issued direct to the stockholders as paid-up stock, the new stock is not to be deemed income, whether she retained it or converted it into cash by sale. If such a different result can flow merely from the difference in the method pursued, it must be because Congress is without power to tax as income of the stockholder either the stock received under the latter method or the proceeds of its sale; for Congress has, by the provisions in the Revenue Act of 1916, expressly declared its purpose to make stock dividends, by whichever method paid, taxable as income.

The Sixteenth Amendment proclaimed February 25, 1913, declares:

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The Revenue Act of September 8, 1916, c. 463, 39 Stat. 756, 757, provided:

"That the term 'dividends' as used in this title shall

be held to mean any distribution made or ordered to be made by a corporation, . . . out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation . . . which stock dividend shall be considered income, to the amount of its cash value."

Hitherto powers conferred upon Congress by the Constitution have been liberally construed, and have been held to extend to every means appropriate to attain the end sought. In determining the scope of the power the substance of the transaction, not its form has been regarded. *Martin* v. *Hunter*, 1 Wheat. 304, 326; *McCulloch* v. *Maryland*, 4 Wheat. 316, 407, 415; *Brown* v. *Maryland*, 12 Wheat. 419, 446; *Craig* v. *Missouri*, 4 Pet. 410, 433; *Jarrolt* v. *Moberly*, 103 U. S. 580, 585, 587; *Legal Tender Case*, 110 U. S. 421, 444; *Burrow-Giles Lithographic Co.* v. *Sarony*, 111 U. S. 53, 58; *United States* v. *Realty Co.*, 163 U. S. 427, 440, 441, 442; *South Carolina* v. *United States*, 199 U. S. 437, 448–9. Is there anything in the phraseology of the Sixteenth Amendment or in the nature of corporate dividends which should lead to a departure from these rules of construction and compel this court to hold, that Congress is powerless to prevent a result so extraordinary as that here contended for by the stockholder?

First: The term "income" when applied to the investment of the stockholder in a corporation, had, before the adoption of the Sixteenth Amendment, been commonly understood to mean the returns from time to time received by the stockholder from gains or earnings of the corporation. A dividend received by a stockholder from a corporation may be either in distribution of capital assets or in distribution of profits. Whether it is the one or the other is in no way affected by the medium in which it is paid, nor by the method or means through which the particular thing distributed as a dividend was procured. If the

dividend is declared payable in cash, the money with which to pay it is ordinarily taken from surplus cash in the treasury. But (if there are profits legally available for distribution and the law under which the company was incorporated so permits) the company may raise the money by discounting negotiable paper; or by selling bonds, scrip or stock of another corporation then in the treasury; or by selling its own bonds, scrip or stock then in the treasury; or by selling its own bonds, scrip or stock issued expressly for that purpose. How the money shall be raised is wholly a matter of financial management. The manner in which it is raised in no way affects the question whether the dividend received by the stockholder is income or capital; nor can it conceivably affect the question whether it is taxable as income.

Likewise whether a dividend declared payable from profits shall be paid in cash or in some other medium is also wholly a matter of financial management. If some other medium is decided upon, it is also wholly a question of financial management whether the distribution shall be, for instance, in bonds, scrip or stock of another corporation or in issues of its own. And if the dividend is paid in its own issues, why should there be a difference in result dependent upon whether the distribution was made from such securities then in the treasury or from others to be created and issued by the company expressly for that purpose? So far as the distribution may be made from its own issues of bonds, or preferred stock created expressly for the purpose, it clearly would make no difference in the decision of the question whether the dividend was a distribution of profits, that the securities had to be created expressly for the purpose of distribution. If a dividend paid in securities of that nature represents a distribution of profits Congress may, of course, tax it as income of the stockholder. Is the result different where the security distributed is common stock?

Suppose that a corporation having power to buy and sell its own stock, purchases, in the interval between its regular dividend dates, with monies derived from current profits, some of its own common stock as a temporary investment, intending at the time of purchase to sell it before the next dividend date and to use the proceeds in paying dividends, but later, deeming it inadvisable either to sell this stock or to raise by borrowing the money necessary to pay the regular dividend in cash, declares a dividend payable in this stock:—Can anyone doubt that in such a case the dividend in common stock would be income of the stockholder and constitutionally taxable as such? See *Green* v. *Bissell*, 79 Connecticut, 547; *Leland* v. *Hayden*, 102 Massachusetts, 542. And would it not likewise be income of the stockholder subject to taxation if the purpose of the company in buying the stock so distributed had been from the beginning to take it off the market and distribute it among the stockholders as a dividend, and the company actually did so? And proceeding a short step further: Suppose that a corporation decided to capitalize some of its accumulated profits by creating additional common stock and selling the same to raise working capital, but after the stock has been issued and certificates therefor are delivered to the bankers for sale, general financial conditions make it undesirable to market the stock and the company concludes that it is wiser to husband, for working capital, the cash which it had intended to use in paying stockholders a dividend, and, instead, to pay the dividend in the common stock which it had planned to sell: Would not the stock so distributed be a distribution of profits—and, hence, when received, be income of the stockholder and taxable as such? If this be conceded, why should it not be equally income of the stockholder, and taxable as such, if the common stock created by capitalizing profits, had been originally created for the express purpose of being dis-

tributed as a dividend to the stockholder who afterwards received it?

Second: It has been said that a dividend payable in bonds or preferred stock created for the purpose of distributing profits may be income and taxable as such, but that the case is different where the distribution is in common stock created for that purpose. Various reasons are assigned for making this distinction. One is that the proportion of the stockholder's ownership to the aggregate number of the shares of the company is not changed by the distribution. But that is equally true where the dividend is paid in its bonds or in its preferred stock. Furthermore, neither maintenance nor change in the proportionate ownership of a stockholder in a corporation has any bearing upon the question here involved. Another reason assigned is that the value of the old stock held is reduced approximately by the value of the new stock received, so that the stockholder after receipt of the stock dividend has no more than he had before it was paid. That is equally true whether the dividend be paid in cash or in other property, for instance, bonds, scrip or preferred stock of the company. The payment from profits of a large cash dividend, and even a small one, customarily lowers the then market value of stock because the undivided property represented by each share has been correspondingly reduced. The argument which appears to be most strongly urged for the stockholders is, that when a stock dividend is made, no portion of the assets of the company is thereby segregated for the stockholder. But does the issue of new bonds or of preferred stock created for use as a dividend result in any segregation of assets for the stockholder? In each case he receives a piece of paper which entitles him to certain rights in the undivided property. Clearly segregation of assets in a physical sense is not an essential of income. The year's gains of a partner are taxable as income, although there, likewise, no

segregation of his share in the gains from that of his partners is had.

The objection that there has been no segregation is presented also in another form. It is argued that until there is a segregation, the stockholder cannot know whether he has really received gains; since the gains may be invested in plant or merchandise or other property and perhaps be later lost. But is not this equally true of the share of a partner in the year's profits of the firm or, indeed, of the profits of the individual who is engaged in business alone? And is it not true, also, when dividends are paid in cash? The gains of a business, whether conducted by an individual, by a firm or by a corporation, are ordinarily reinvested in large part. Many a cash dividend honestly declared as a distribution of profits, proves later to have been paid out of capital, because errors in forecast prevent correct ascertainment of values. Until a business adventure has been completely liquidated, it can never be determined with certainty whether there have been profits unless the returns have at least exceeded the capital originally invested. Business men, dealing with the problem practically, fix necessarily periods and rules for determining whether there have been net profits—that is income or gains. They protect themselves from being seriously misled by adopting a system of depreciation charges and reserves. Then, they act upon their own determination, whether profits have been made. Congress in legislating has wisely adopted their practices as its own rules of action.

Third: The Government urges that it would have been within the power of Congress to have taxed as income of the stockholder his *pro rata* share of undistributed profits earned, even if no stock dividend representing it had been paid. Strong reasons may be assigned for such a view. See *Collector* v. *Hubbard*, 12 Wall. 1. The undivided share of a partner in the year's undistributed profits of his firm

is taxable as income of the partner, although the share in the gain is not evidenced by any action taken by the firm. Why may not the stockholder's interest in the gains of the company? The law finds no difficulty in disregarding the corporate fiction whenever that is deemed necessary to attain a just result. *Linn & Lane Timber Co.* v. *United States*, 236 U. S. 574; see Morawetz on Corporations, 2d ed., §§ 227–231; Cook on Corporations, 7th ed., §§ 663, 664. The stockholder's interest in the property of the corporation differs, not fundamentally but in form only, from the interest of a partner in the property of the firm. There is much authority for the proposition that, under our law, a partnership or joint stock company is just as distinct and palpable an entity in the idea of the law, as distinguished from the individuals composing it, as is a corporation.[1] No reason appears, why Congress, in legislating under a grant of power so comprehensive as that authorizing the levy of an income tax, should be limited by the particular view of the relation of the stockholder to the corporation and its property which may, in the absence of legislation, have been taken by this court. But we have no occasion to decide the question whether Congress might have taxed to the stockholder his undivided share of the corporation's earnings. For Congress has in this act limited the income tax to that share of the stockholder in the earnings which is, in effect, distributed by means of the stock dividend paid. In other words, to render the stockholder taxable there must be both earnings made *and* a dividend paid. Neither earnings without dividend—nor a dividend without earnings—subjects the

[1] See "Some Judicial Myths," by Francis M. Burdick, 22 Harvard Law Review, 393, 394–396; The Firm as a Legal Person, by William Hamilton Cowles, 57 Cent. L. J., 343, 348; The Separate Estates of Non-Bankrupt Partners, by J. D. Brannan, 20 Harvard Law Review, 589–592; compare Harvard Law Review, Vol. 7, p. 426; Vol. 14, p. 222; Vol. 17, p. 194.

stockholder to taxation under the Revenue Act of 1916.

Fourth: The equivalency of all dividends representing profits, whether paid in cash or in stock, is so complete that serious question of the taxability of stock dividends would probably never have been made, if Congress had undertaken to tax only those dividends which represented profits earned during the year in which the dividend was paid or in the year preceding. But this court, construing liberally not only the constitutional grant of power but also the Revenue Act of 1913, held that Congress might tax, and had taxed, to the stockholder dividends received during the year, although earned by the company long before; and even prior to the adoption of the Sixteenth Amendment. *Lynch* v. *Hornby*, 247 U. S. 339.[1] That rule, if indiscriminatingly applied to all stock dividends representing profits earned, might, in view of corporate practice, have worked considerable hardship, and have raised serious questions. Many corporations, without legally capitalizing any part of their profits, had assigned definitely some part or all of the annual balances remaining after paying the usual cash dividends, to the uses to which permanent capital is ordinarily applied. Some of the corporations doing this, transferred such balances on their books to "Surplus" account,—distinguishing between such permanent "Surplus" and the "Undivided Profits" account. Other corporations, without this formality, had assumed that the annual accumulating balances carried as undistributed profits were to be treated as capital permanently invested in the business. And still others, without definite assumption of any kind, had

[1] The hardship supposed to have resulted from such a decision has been removed in the Revenue Act of 1916, as amended, by providing in § 31 (b) that such cash dividends shall thereafter be exempt from taxation, if before they are made, all earnings made since February 28, 1913, shall have been distributed. Act of October 3, 1917, c. 63, § 1211, 40 Stat. 338; Act of February 24, 1919, c. 18, § 201 (b), 40 Stat. 1059.

so used undivided profits for capital purposes. To have made the revenue law apply retroactively so as to reach such accumulated profits, if and whenever it should be deemed desirable to capitalize them legally by the issue of additional stock distributed as a dividend to stockholders, would have worked great injustice. Congress endeavored in the Revenue Act of 1916 to guard against any serious hardship which might otherwise have arisen from making taxable stock dividends representing accumulated profits. It did not limit the taxability to stock dividends representing profits earned within the tax year or in the year preceding; but it did limit taxability to such dividends representing profits earned since March 1, 1913. Thereby stockholders were given notice that their share also in undistributed profits accumulating thereafter was at some time to be taxed as income. And Congress sought by § 3 to discourage the postponement of distribution for the illegitimate purpose of evading liability to surtaxes.

Fifth: The decision of this court, that earnings made before the adoption of the Sixteenth Amendment but paid out in cash dividend after its adoption were taxable as income of the stockholder, involved a very liberal construction of the Amendment. To hold now that earnings both made and paid out after the adoption of the Sixteenth Amendment cannot be taxed as income of the stockholder, if paid in the form of a stock dividend, involves an exceeding narrow construction of it. As said by Mr. Chief Justice Marshall in *Brown* v. *Maryland*, 12 Wheat. 419, 446: "To construe the power so as to impair its efficacy, would tend to defeat an object, in the attainment of which the American public took, and justly took, that strong interest which arose from a full conviction of its necessity."

No decision heretofore rendered by this court requires us to hold that Congress, in providing for the taxation of

stock dividends, exceeded the power conferred upon it by the Sixteenth Amendment. The two cases mainly relied upon to show that this was beyond the power of Congress are *Towne* v. *Eisner*, 245 U. S. 418, which involved a question not of constitutional power but of statutory construction, and *Gibbons* v. *Mahon*, 136 U. S. 549, which involved a question arising between life-tenant and remainderman. So far as concerns *Towne* v. *Eisner*, we have only to bear in mind what was there said (p. 425): "But it is not necessarily true that income means the same thing in the Constitution and the [an] act." [1] *Gibbons* v. *Mahon* is even less an authority for a narrow construction of the power to tax incomes conferred by the Sixteenth Amendment. In that case the court was required to determine how, in the administration of an estate in the District of Columbia, a stock dividend, representing profits, received after the decedent's death, should be disposed of as between life-tenant and remainderman. The question was in essence: What shall the intention of the testator be presumed to have been? On this question there was great diversity of opinion and practice in the courts of English-speaking countries. Three well-defined rules were then competing for acceptance; two of these involve an arbitrary rule of distribution, the third equitable apportionment. See Cook on Corportions, 7th ed., §§ 552–558.

1. The so-called English rule, declared in 1799, by *Brander* v. *Brander*, 4 Ves. Jr. 800, that a dividend rep-

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[1] Compare Rugg, C. J., in *Tax Commissioner* v. *Putnam*, 227 Massachusetts, 522, 533: "However strong such an argument might be when urged as to the interpretation of a statute, it is not of prevailing force as to the broad considerations involved in the interpretation of an amendment to the Constitution adopted under the conditions preceding and attendant upon the ratification of the Forty-fourth Amendment."

resenting profits, whether in cash, stock or other property, belongs to the life-tenant if it was a regular or ordinary dividend, and belongs to the remainderman if it was an extraordinary dividend.

2. The so-called Massachusetts rule, declared in 1868 by *Minot* v. *Paine*, 99 Massachusetts, 101, that a dividend representing profits, whether regular, ordinary or extraordinary, if in cash belongs to the life-tenant, and if in stock belongs to the remainderman.

3. The so-called Pennsylvania rule declared in 1857 by *Earp's Appeal*, 28 Pa. St. 368, that where a stock dividend is paid, the court shall inquire into the circumstances under which the fund had been earned and accumulated out of which the dividend, whether a regular, an ordinary or an extraordinary one, was paid. If it finds that the stock dividend was paid out of profits earned since the decedent's death, the stock dividend belongs to the life-tenant; if the court finds that the stock dividend was paid from capital or from profits earned before the decedent's death, the stock dividend belongs to the remainderman.

This court adopted in *Gibbons* v. *Mahon* as the rule of administration for the District of Columbia the so-called Massachusetts rule, the opinion being delivered in 1890 by Mr. Justice Gray. Since then the same question has come up for decision in many of the States. The so-called Massachusetts rule, although approved by this court, has found favor in only a few States. The so-called Pennsylvania rule, on the other hand, has been adopted since by so many of the States (including New York and California), that it has come to be known as the "American Rule." Whether, in view of these facts and the practical results of the operation of the two rules as shown by the experience of the thirty years which have elapsed since the decision in *Gibbons* v. *Mahon*, it might be desirable for this court to reconsider the question there decided, as

some other courts have done (see 29 Harvard Law Review, 551), we have no occasion to consider in this case. For, as this court there pointed out (p. 560), the question involved was one "between the owners of successive interests in particular shares," and not, as in *Bailey* v. *Railroad Co.*, 22 Wall. 604, a question "between the corporation and the government, and [which] depended upon the terms of a statute carefully framed to prevent corporations from evading payment of the tax upon their earnings."

We have, however, not merely argument, we have examples which should convince us that "there is no inherent, necessary and immutable reason why stock dividends should always be treated as capital." *Tax Commissioner* v. *Putnam*, 227 Massachusetts, 522, 533. The Supreme Judicial Court of Massachusetts has steadfastly adhered, despite ever-renewed protest, to the rule that every stock dividend is, as between life-tenant and remainderman, capital and not income. But in construing the Massachusetts Income Tax Amendment, which is substantially identical with the Federal Amendment, that court held that the legislature was thereby empowered to levy an income tax upon stock dividends representing profits. The courts of England have, with some relaxation, adhered to their rule that every extraordinary dividend is, as between life-tenant and remainderman, to be deemed capital. But in 1913 the Judicial Committee of the Privy Council held that a stock dividend representing accumulated profits was taxable like an ordinary cash dividend, *Swan Brewery Co., Ltd.*, v. *Rex*, [1914] A. C. 231. In dismissing the appeal these words of the Chief Justice of the Supreme Court of Western Australia were quoted (p. 236), which show that the facts involved were identical with those in the case at bar: "Had the company distributed the 101,450£ among the shareholders and had the shareholders repaid such sums to the company as the price of the 81,160 new shares, the duty on the 101,450£

would clearly have been payable. Is not this virtually the effect of what was actually done? I think it is."

Sixth: If stock dividends representing profits are held exempt from taxation under the Sixteenth Amendment, the owners of the most successful businesses in America will, as the facts in this case illustrate, be able to escape taxation on a large part of what is actually their income. So far as their profits are represented by stock received as dividends they will pay these taxes not upon their income but only upon the income of their income. That such a result was intended by the people of the United States when adopting the Sixteenth Amendment is inconceivable. Our sole duty is to ascertain their intent as therein expressed.[1] In terse, comprehensive language befitting the Constitution, they empowered Congress "to lay and collect taxes on incomes, from whatever source derived." They intended to include thereby everything which by reasonable understanding can fairly be regarded as income. That stock dividends representing profits are so regarded, not only by the plain people but by investors and financiers, and by most of the courts of the country, is shown, beyond peradventure, by their acts and by their utterances. It seems to me clear, therefore, that Congress possesses the power which it exercised to make dividends representing profits, taxable as income, whether the medium in which the dividend is paid be cash or stock, and that it may define, as it has done, what dividends repre-

[1] Compare Rugg, C. J., *Tax Commissioner* v. *Putnam*, 227 Massachusetts, 522, 524: "It is a grant from the sovereign people and not the exercise of a delegated power. It is a statement of general principles and not a specification of details. Amendments to such a charter of government ought to be construed in the same spirit and according to the same rules as the original. It is to be interpreted as the Constitution of a State and not as a statute or an ordinary piece of legislation. Its words must be given a construction adapted to carry into effect its purpose."

senting profits shall be deemed income. It surely is not clear that the enactment exceeds the power granted by the Sixteenth Amendment. And, as this court has so often said, the high prerogative of declaring an act of Congress invalid, should never be exercised except in a clear case.[1] "It is but a decent respect due to the wisdom, the integrity and the patriotism of the legislative body, by which any law is passed, to presume in favor of its validity, until its violation of the Constitution is proved beyond all reasonable doubt." *Ogden* v. *Saunders*, 12 Wheat. 213, 270.

MR. JUSTICE CLARKE concurs in this opinion.

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[1] "It is our duty, when required in the regular course of judicial proceedings, to declare an act of Congress void if not within the legislative power of the United States; but this declaration should never be made except in a clear case. Every possible presumption is in favor of the validity of a statute, and this continues until the contrary is shown beyond a rational doubt. One branch of the government cannot encroach on the domain of another without danger. The safety of our institutions depends in no small degree on a strict observance of this salutary rule." *Sinking-Fund Cases*, 99 U. S. 700, 718 (1878). See also *Legal Tender Cases*, 12 Wall. 457, 531 (1870); *Trade-Mark Cases*, 100 U. S. 82, 96 (1879). See American Doctrine of Constitutional Law, by James B. Thayer, 7 Harvard Law Review, 129, 142.

"With the exception of the extraordinary decree rendered in the Dred Scott Case, . . . all of the acts or the portions of the acts of Congress invalidated by the courts before 1868 related to the organization of courts. Denying the power of Congress to make notes legal tender seems to be the first departure from this rule." Haines, American Doctrine of Judicial Supremacy, p. 288. The first legal tender decision was overruled in part two years later (1870), *Legal Tender Cases*, 12 Wall. 457; and again in 1883, *Legal Tender Case*, 110 U. S. 421.